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# ***Developing SMEs Through Large Firm-Small Firm Linkages: The Kenyan Motor Vehicle Assembly Industry***

***Catherine Kadenyeka Madete Masinde [B Ed; MBA]***

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Thesis submitted in fulfilment of the Degree of  
**Doctor of Philosophy**

**UNIVERSITY OF DURHAM (Dunelm)**

**April 1994**



**27 JUL 1994**



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*There's nothing more difficult to execute, nor more dubious of success, nor more dangerous to administer than to introduce a new order of things; for he who introduces it has all those who profit from the old order as his enemies, and he has only lukewarm allies in those who might profit from the new.*

*(Machiavelli. The Prince)*

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***For my Children***

***Joyce Alexandria Nakhungu***

***Mellanie Faith Nelima***

***and***

***Rebecca Nasimiyu***

---

Catherine K M Masinde

***Developing SMEs Through Large Firm- Small Firm Linkages: The Kenyan  
Vehicle Assembly Industry***

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1994

***ABSTRACT***

This thesis aims to explore the prospects for small and medium enterprise (SME) development using inter-firm linkages between large and small firms in Kenya. A wide range of strategies has been adopted already for the development of small enterprises globally, but limited use appears to have been made, outside Japan, of inter-firm linkages as a specific strategy. Despite the recent global movement towards inter-firm relationships as a strategy for achieving efficiency through the down-sizing of large firms, externalisation of activities, and adoption of lean production techniques, no attempt appears to have been made to use the strategy for SME development, possibly because little is known about how inter-firm linkages between large and small firms are formed. This thesis aims to contribute to the development of this understanding by using an inductive, qualitative research approach to explore the factors influencing the sourcing strategies of large firms in Kenya, to determine whether these have some potential for SME development both in the country and more generally. The study focuses on the Kenyan vehicle assembly industry and examines, through in-depth case studies, the sourcing activities of three vehicle assembly plants and four franchise holders.

Overall, the research lends support to the argument that for various reasons largely related to market failure, and a non-conducive business environment, large firms in Kenya's motor vehicle industry are reluctant to outsource voluntarily from local small firms, and that when they do, relations appear to be arms-length and adversarial. The research also reveals that in the Kenyan environment, contrary to the arguments of transaction cost theory, outsourcing decisions are predicated on the need to comply with compulsory regulations in order to gain access to resources and markets, rather than primarily on cost minimisation. Consequently, strategies which assure access to resources such as foreign exchange and import licenses were found to override purely efficiency considerations.

The findings imply that although there are some prospects for SME development using this approach, the selection of small enterprises as suppliers by managers of large firms is limited by large firms' perceptions of the suitability of such suppliers, and that if SME development is to take place through such linkages, strategies which either change the image of small suppliers, or improve the attitudes of large buyers have to be adopted.

## ***ACKNOWLEDGEMENTS***

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Despite the teamwork which has produced this thesis, I assume full responsibility for all errors of omission and commission which remain.

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# **CHAPTER ONE**

## **INTRODUCTION**

### **1.1 PURPOSE OF THE RESEARCH**

This study aims to explore the prospects for SME development through linkages between large and small firms in a developing country, Kenya. Since the ILO Mission (1972) to Kenya on employment, the informal and small enterprise (SSE) sectors have received considerable attention as potential job generators, and vehicles for economic regeneration (GOK, 1986). Yet, the strategies adopted for the promotion of these sectors to date have focused on the development of institutions and programmes which promote them separately rather than as part of an industrial system which recognises the complementarity of various sizes of firms in an industry. Consequently, their contribution to employment or to national output in Kenya has remained small (World Bank, 1987).

The genesis of this study is the desire to develop an approach for linking various sizes of firms in industry, ostensibly, to achieve the advantages of a size distribution of industry reported elsewhere (Watanabe, 1983). Stimulated by the flexible specialisation paradigm, and its implications for work organisation, and pressured by prevailing economic conditions, current international thinking about work organisation supports such a strategy. Further, the dominance of large firms, which have continued to condition the social and institutional structure in developing countries, could be addressed by encouraging collaborative or competitive linkages between large and small firms. Yet, little research exists which explicitly explains how large firms can be encouraged and used to develop such linkages. This study aims to address this broad question.

### **1.2 OVERVIEW**

Considerable research highlights the importance of SMEs in industrial development (Watanabe, 1971, 1972; Sengenberger et al., 1987), particularly in manufacturing (Watanabe, 1971, 1972; Sengenberger and Loveman, 1987; Rothwell, 1989), their implications for regional development (Storey and Johnson, 1987; Keeble and Wever, 1986; Shutt and Whittington, 1986), and their role in the export performance of industries (Minato, 1992). Further, various researchers have suggested their importance to large firms, exploring their role in technology generation and transfer in collaboration with, and providing services to large firms (Rothwell, 1989; Rothwell and Zegveld, 1982), providing supply and distribution networks (Beccatini, 1990; Watanabe, 1972; Sato, 1989; Brusco, 1986; Bade, 1986), or services (Beccatini, 1990). Apparent in these arguments

is the premise that small firms can, and do provide synergy within an industrial system, and that the viability of that system depends, to a large extent, on a size distribution of production between large and small firms. Arguably, in developing countries, SMEs also play the role of redistributing resources by penetrating resource control networks formerly concentrated in the hands of a few people (De Soto, 1989), in addition to increased competition introduced into hitherto highly concentrated industries. The wider implication of this is a possible redistribution of wealth as formerly exclusive ownership is gradually opened up to more people in the society. This study views SMEs as having this more socio-political role of dispersing excessive centralisation of resources control, possibly leading to their redistribution.

Despite this importance of the complementarity of SMEs to other firms in the industrial structure, and also as demonstrated in the Japanese economy (Watanabe, 1971; 1972; Friedmann, 1988), western and developing countries' approaches to their promotion have hitherto been limited to developing assistance institutions and programmes aimed at assisting SMEs; development of the policy environment in which SMEs operate; and encouragement of the growth of the SMEs themselves (Gibb, 1993). Limited use has been made of inter-firm linkages as a specific strategy for SME development, despite widespread acknowledgement of the success of Japanese manufacturing being largely attributed to a deliberate strategy to encourage complementarity between the various sizes of firms in industries and the Italian experience where SMEs have had significant contributions in industrial development alongside, and in spite of, large firms (Weiss, 1988). A linkage strategy is based on inter-firm relationships which emanate from contractual and collaborative relationships, yet this phenomenon is neither developed nor understood in many economies.

It is important to define, at this juncture, the concept of inter-firm linkages as used in this study. In the context and scope of this study, this means any form of relationship between different firms, in particular, between large and small firms. This study does not limit the discussion to sub-contracting relationships although these are recognised as the most frequently used and documented forms of inter-firm linkages, since the potential for other relationships such as joint ventures, licensing and franchising exist.

*Why a linkage strategy?* - The main rationale for a linkage strategy for small enterprise development as adopted by this study, lies in the broader logic of shifting production from large to small industries, requiring large firms to externalise production activities to small firms as suggested by the 'flexible specialisation' paradigm. In spite of the controversies surrounding its practical applications, this paradigm emphasises some concepts which provide a broad framework within which to analyse size related production distribution in industry: flexible work organisation, external input and process sourcing, clustering and networking of suppliers, market segmentation

and vertical disintegration of enterprises (Best, 1990; Piore and Sabel, 1984; Sabel, 1982). Since the seminal work by Piore and Sabel in 1984, world thinking has shifted from mass production to 'flexible' forms of production where economies of scope are argued to be more important than economies of scale as the importance of fixed costs declines. At the same time, current management theory in the west argues that more flexible systems are required for the increased volatility in demand, and increased customisation of goods and services, and hence a movement away from Fordist modes of production. In some cases such as in developing country contexts, however, it is the small and fragmented internal markets which make the paradigm appealing by questioning the relevance of the principles and philosophy of mass production in environments where domestic markets are small and fragmented and prospects for export are limited. While the debate about the appropriateness of large versus small forms of production continues (Piore and Sabel, 1984; Weiss, 1988), European and American management specialists have gone on to counsel large firm disaggregation and adoption of flexible production and labour organisation (Kanter, 1989; Peters, 1987; Drucker, 1985) as strategies of competitive advantage. Although the effects of these measures and their wider implications have not been tested, it appears that firms are fragmenting more (Pettigrew, 1985).

At this juncture, it is important to emphasise that although the themes of 'lean production', 'flexible production', and 'post-fordism' have separate identities and emphasise differing underlying concepts, they cover the common phenomenon of firm de-integration and the use of inter-firm linkages as a mechanism for supplier chain management. Hence, it is the 'externalisation' logic which interests this study. Consequently, in ensuing discussions in subsequent chapters about these themes, it is the linkage variant of flexible production, involving vertical links between large and small firms, which is considered, rather than the small firm collaboration variant described by authors such as Brusco (1986).

These fragmentation decisions and the concomitant outsourcing activities stimulate some fundamental questions. (i) what factors influence the firm's decision to externalise its activities to others outside the firm; (ii) what factors influence the firm's decisions about who to externalise these activities to; and (iii) the nature of the relationship with such outside suppliers should the firm decide to externalise, which, in turn, defines the kind of markets to be used subsequent to fragmentation.

One possible explanation for the limited use of linkage strategies for SME development is, perhaps, the current paucity of knowledge about the requisite conditions for inter-organisational relationships (IORs), particularly those between large and small firms. The current knowledge is either too specific to particular forms of inter-firm relationships, many of them studied in the context of large public organisations, or is itself theoretically fragmentary (Oliver, 1990). Besides,



some of the underlying assumptions made about the reasons for some of the inter-firm relationships restrict the wider use of emergent theories, and hence the need for an integrated theory which brings together these requisite conditions.

*Why the focus on large firms?* Whereas other issues are material to understanding these conditions, for example factors relating specifically to SMEs as suppliers or to the environment within which both suppliers and buyers operate, this study recognises that as an initial step towards filling this gap, it is expedient to explore the intrinsic behaviour of the buying firms, in this case large firms, since (i) given the current production organisation paradigm supporting mass production, what goes on in an industry is an aggregate of what goes on in key firms, usually large firms, relative to other firms; (ii) large firms still dominate the industrial production of most economies; and (iii) given existing production organisation, collaborative linkages between large and small firms are more likely to be initiated by large firms rather than by small firms.

In short, the focus on large firms is based on the premise that aggregate industrial behaviour is the result of intrinsic corporate decisions at individual firm level, particularly those decisions taken by large firms. Hence, such decisions are likely to determine, to a large extent, the division of labour among firms, resource distribution, and interorganisational relationships in that industry. In addition, the development of SMEs through linkages with large firms will depend on such decisions taken inside large firms. Besides, Kelley and Harrison (1990) argue in their study of subcontracting behaviour among single plant and multi-plant firms in the USA, that there is a size related hierarchy among firms, and that larger firms are more likely to instigate inter-firm relationships for the simple reason that they are likely to be leaders in their own industry. Relationships with smaller firms are likely to be instigated and 'managed', therefore, by large firms.

### **1.3 JUSTIFICATION OF THE STUDY**

This study is justified at two levels. The desire to contribute to the development of SMEs using an inter-firm linkage strategy in Kenya; and the search for an 'explanation' for inter-firm linkages between large and small firms.

#### **1.3.1 PRACTICAL JUSTIFICATION: KENYA**

The main rationale for this study lies in Kenya's search for an economic development strategy which can generate employment and regenerate the economy (GOK, 1984, 1986, 1989). Increasing attention has been focused on the informal and small scale sectors since the 1972 ILO Mission on Kenya's unemployment problem highlighted the potential of these sectors as sources of new jobs, technological innovation, and acquisition of management skills. In its blueprint for

renewed economic growth contained in Sessional Paper no. 1 of 1986, Kenya emphasised, *inter alia*, the development of its Small Enterprise Sector (SSE), as part of a broader strategy to utilise economic capacity, transfer ownership to indigenous Kenyans, reduce the import bill, propel the development and transfer of technology, and absorb unemployed youth (GOK, 1986). However, this role ascribed to SMEs has not been fully realised, partly because of the inherent weakness of the small enterprise sector itself (World Bank, 1987; Kilby, 1987), and partly because of the continued dominance of large firms, and its implications for the production distribution of industry. Currently, about 70% of Kenya's manufacturing value added is attributed to large firms. Arguably therefore, in Kenya, the development of the SME sector will depend on the strength (or weakness) of its links with large firms which already condition the social and institutional structure, as well as the input and final markets in the economy, and to a large extent, play a key role in national politics and resource distribution.

Given this dominance of large firms, the inherent weaknesses of the SME sector in Kenya, and the premise that aggregate industrial behaviour is in fact the result of internal corporate strategies, it is important to explore what goes on inside large firms, and the reasons and nature of their inter-organisational relationships, particularly with small firms. It can be argued that the effectiveness of policies to develop SMEs would be, in part, a function of the extent to which these large firms can, and will, link with small firms, and the requisite conditions for such linkages. In addition, the development of the sector in isolation from other actors in specific industries has contributed to the limited realisation of the potential of the complementarity between large and small firms, even while various national development goals support such a complementarity. Consequently, the national strategy for SME development does not clearly define the role of this sector vis a vis the large firm sector (GOK, 1986; 1992), undermining the potential for a more efficient size distribution of labour in industrial production.

Against this background, it becomes apparent that in order to succeed, SME development strategies must take into account and collaborate with large firms as suppliers or partners, hence the proposal for a linkage strategy. The study is premised, therefore, on two gaps. First, in addition to the deficiency in the volume and quality of SMEs in Kenya's industrial structure, links between large and small firms are weak, principally explained by the dominance of the large firms sector and the weakness of the SME sector itself. Secondly, little is known about how to motivate large firms to form useful linkages with small firms in developing countries in general, and Kenya in particular. Although specific explanations for inter-firm relationships were found in the literature, no integrated framework was found which explains how and why large firms link with small firms as partners or suppliers. Moreover, information about such inter-firm linkages in developing country contexts, if any, is limited.



*Why a linkage strategy in Kenya?* - Apart from the argument that industrial behaviour is an aggregate of corporate decisions taken in response to the task environment, particularly by large firms in an industry, three other arguments provide a rationale for SME development through a linkage strategy in Kenya - (i) the current dominance of large firms in Kenya's economy, particularly their relative power over resources and markets, and the simultaneous weakness of the SME sector; (ii) an apparent mismatch between the current low internal demand for goods and services in Kenya, and the philosophy and practice of mass production; (iii) Kenya's industrialisation goals which favour disaggregation of large firms, and linkages between large and small firms.

(1) The first argument for a linkage strategy recognises that despite the widely acknowledged role of SMEs in industrial development and manufacturing, and the positive experiences of developed as well as developing economies, for various reasons, the SME sector in Kenya is not adequately developed. Consequently, the supply network supporting the large enterprises sector is weak. The United Nations Industrial Development Organisation (UNIDO) estimated, albeit conservatively, that in 1985, the 560 large firms employing more than 100 people, were serviced by 720 small firms and 1600 Informal sector workshops (UNIDO, 1988). Even while a recent estimate shows, for example, that there were about 350,000 small workshops and service businesses in Kenya by 1990, they still accounted for 22% of value added in manufacturing. This paucity of modern small scale manufacturing establishments has been blamed by the World Bank for "the major weakness of Kenya's industrial development" (World Bank, 1987:210). While acknowledging this paucity, and recognising that the SME sector is likely to improve economic performance, the strategies adopted by the government to achieve it have been delayed, weak and uncoordinated. Further, government macro-economic policies have continued to support large firms at the expense of small firms (Coughlin, 1988; Kaplinsky, 1978; Langdon, 1978; Swainson, 1980). Hence, large firms in Kenya have continued to dominate the business environment, erecting barriers to entry through the control of resources and markets (Nyong'o, 1988; Ikiara, 1988; Coughlin, 1991), contributing further to the weakening of the SME sector. Hence, in an environment such as the one prevailing in Kenya, where large firms already dominate the economy, the development of SMEs largely depends on whether the large firms will 'allow' small firms to develop. This implies a major shift in Kenya's political economy, with major power shifts in the ownership and control of resources, not only between large and small, but also between foreign and indigenous Kenyan capital. To date, little or no linkage between large and small firms has been deliberately used or encouraged in planning national production organisation, and few government initiatives exist which encourage the use of such linkages.

One possible explanation for the scenario described above is the lack of understanding by government policy makers, and large and small firms themselves, of the role and implications of a

size distribution of industry where small firms play a supportive role to large firms. No empirical work exists on linkages between large and small firms, or on their combined role as part of a productive system in Kenya. Hence, ambiguity surrounds the advantages of the use of such linkages, probably accounting for the low levels of linkage between large and small firms (GOK, 1986). Another possible explanation for low levels of linkages is the traditionally adversarial relationship between large and small firms, partly caused by the initial role assigned by the government to small firms soon after independence - as a vehicle for Kenyanisation of the economy (GOK, 1965), and the anticipation that such action would lead to the acquisition of productive resources by indigenous Kenyans. Even when current conditions in the business environment, and the experiences of other countries, suggest collaboration between the two sectors, there is little evidence of inter-firm relationships between large and small firms in Kenya. This study intends to explore some of the underlying causes of this situation.

Underlying this scenario is a possible perceived threat to the power position of large firms implicit in disaggregation and/or collaboration with small firms (Pfeffer and Salancik, 1978). Perceived power and control loss through these processes could be 'threatening' to a firm, as it could imply structural and size adjustments, sharing of information, reliance on parties outside the control of the firm, and uncertainty in the tenure of relationships arising therefrom. The implied collaboration and partnership with small firms is itself a further potential threat to the existing power balance in the political economy of particular industries. Similarly, for the small firm, the prospects of dealing with the 'giants' can be daunting in the face of a weak knowledge and technology base resulting from historical developments of small firms in Kenya (GOK, 1989) where SMEs have remained technologically and managerially weaker than their larger counterparts. Given the present precarious power balance, researchers must study what motivates large firms to interact with small firms by exploring how large firms organise their production activities, and what motivates such production organisation.

(2) The second rationale for looking to large firms for small enterprise development lies in the logic of 'flexible specialisation' and its implications for work distribution within industries. The logic for externalisation of activities which this paradigm offers, by emphasising flexible work organisation, external input and process sourcing, clustering and networking of suppliers, market segmentation and vertical disintegration of enterprises (Best, 1990; Piore and Sabel, 1984; Sabel, 1982), potentially offers Kenya's industrialisation process the rationale to move away from predominately mass production organisation. One immediate reason which makes this paradigm appealing to developing countries is the "apparent mismatch between the small (internal) markets of developing countries and the philosophy and/or practice of mass production" (Schmitz, 1990:266). Its advantage is therefore the possibility of small batch production of differentiated products targeted at highly fragmented markets. Most of Kenya's markets are small and

fragmented (see, for example, Masai (1991) on the vehicle assembly industry in Kenya), and are further constrained by the low purchasing power of individuals (GOK, 1986). In addition, competition in international markets and the lack of competitiveness of Kenyan goods and services limits the prospects of exploiting export markets. This scenario questions the logic and suitability of the mass production systems in developing economies such as Kenya, particularly when evidence indicates that other economies are seeking industrial competitiveness by moving away from predominantly mass production to 'de-scaled' production systems (Piore and Sabel, 1984; Kaplinsky, 1988).

Additionally, disaggregation and fragmentation of large firms has become a common competitive strategy by large firms in the developed world, as firms seek flexibility and adaptability in the face of volatile business environments (Pralahad and Hamel, 1990). Kenya is progressively acquiring demand patterns and business environments similar to those prevailing in developed countries, and its firms are likely to respond, therefore, to these pressures by reflecting this international standard of large firm disaggregation and decentralisation of work through various externalisation strategies. Kaplinsky (1993) reports in his work on the implementation of JIT in developing countries, that the adoption of this production system has been low and slow due to the 'custom' of mass production regimes, largely owing to the continued protection of many industries which have hitherto not had incentives to adopt competitive production techniques. Moreover, as developing countries open up their markets in response to Structural Adjustment Programmes, firms which have hitherto been protected will have to face external competition, and will necessarily have to adopt production systems and techniques which match those of competitors. Kaplinsky and Posthuma (1993), in a Zimbabwean study, report that those firms implementing JIT strategies were specifically motivated by the threat from this external competition. However, this is likely to be contingent upon the assurance that these large firms can still directly control their resources and markets. For example, the Transnational Corporations (TNCs), which have spearheaded industrial development in developing countries need to be assured that new techniques and programmes preserve their markets.

(3) The third rationale for the linkage strategy in Kenya postulates that its industrialisation goals and strategies articulated by the government, which favour a division of labour between various firm sizes, demand and support disaggregation of large units of production, and/or linkages between large and small firms.

The Kenya Government's plan to restructure the ownership of industry motivates most of its development strategies, recognising that this is "the only way through which nationals will graduate into the competitive system where they can participate on an equal footing with non-Kenyans" (GOK, 1989:153). While the ownership structure of Kenyan industry continues to be

foreign-capital heavy (Vaitsos, 1991), and the emergence of small and medium sized African industrialists in Kenya slow (Kaplinksy, 1982:209-11), this goal cannot be easily achieved. The government sees restructuring as largely possible through joint ventures and partnerships between large foreign firms and small locally owned firms, among other strategies (GOK, 1989). This strategy is particularly appealing for technology development and transfer. Largely due to a weak indigenous technological base, much of the technology currently used in Kenya has come to the country from the west via Multinational Corporations (MNCs) and other foreign firms, whose earlier activities concentrated on domestic processing, packaging of finished goods (Leys, 1975) and assembly of knocked down components. As a result, Kenyan industrialisation has not benefited from a growing complexity of products and/or markets. The government envisages that through linkages between large and smaller local firms, technology transfer can take place.

As part of this strategy to restructure the ownership of industry, and open up markets to increased competition, the government envisages a programme of reduction of monopolies and industrial concentration through the enforcement of The Restrictive Trade Practices, Monopolies and Price Control Act (1988). Large firms predate Kenyan independence in 1963, when MNCs and trading companies were used by the colonial government as quasi-political presences in the colonies. Later, firms which located in Kenya soon after independence perceived the need to control resources in the uncertain business environment inherent in developing economies at the time, and responded by building capacity and integrating vertically. They saw size and vertical integration as adequately offsetting the premium paid by holding excess capacity. This trend has continued, with large firms erecting entry barriers based on economies of scale and resource and distribution channel control. The government, therefore, saw the control of vertical integration as a means of preventing such excessive integration, and encouraging subsequent absorption of excess capacity via inter-firm relationships such as subcontracting arrangements, joint ventures and partnerships. Although there is little empirical evidence indicating the impact of this strategy, casual observation and anecdotal evidence suggest that due to factors such as poor design and policing mechanisms, firms have continued to integrate. On a different level, the current privatisation drive, aimed at reducing the operations of state enterprise, and increasing the efficiency of public organisations as part of the Structural Adjustment Programmes prescribed by the International Monetary Fund (IMF), has made it necessary to re-orient from large to small organisations. The government views this as one opportunity for indigenous Kenyans to enter into the mainstream of industrial development through stockholding or trade links with privatised organisations (GOK, 1989).

### **1.3.2 THEORETICAL JUSTIFICATION: INTER-FIRM RELATIONSHIP FORMATION**

To address the research question, literature on inter-firm relationship formation has been reviewed. Development of SMEs through linkages with large firms is a function of the large firms'



motivation and propensity to form linkages of any kind, particularly those involving small firms. In turn, this is a function of the large firms' motivation and propensity to outsource some or most of its requirements - either externalising activities already performed in-house, or entering into contractual and partnership relationships for new requirements. Evidently, it is the procuring firm that is the focus of activity. Secondly, the generic decision is the make-or-buy decision, which is often affected by a firm's ability to provide requirements using existing resources; and the availability of more 'efficient' suppliers in the market. Each decision is, therefore, a necessary but not sufficient condition for linkage formation. It can be expected that when a firm makes a decision to outsource any requirements, it simultaneously makes decisions about its structure, size and relationships with suppliers. On the other hand, less rational economic motivations can be found. For example, political factors, necessity to comply with legislation, and others. This study simultaneously explores the outsourcing, organisational development and collaborative of competitive linkage formation processes. This part of the literature is elaborated in chapter three.

#### **1.4 AIMS AND OBJECTIVES**

Against this background, the study aims to investigate, therefore, the motivations behind the existing production organisation of large firms in Kenya's motor vehicle industry, and the potential for small enterprise development through linkages with such large firms. The basis of this objective is the argument that externalisation of production by large firms can create an environment where small firms can develop, and that this is determined by the extent to which large firms make decisions to interact with such small firms. This objective was guided by the thesis that like other developing countries where large firms constitute a significant proportion of the industrial structure, large firms in Kenya are reluctant to form collaborative linkages with small firms. In all probability, this reluctance is largely because, in addition to the general market failure in most input markets in these countries, local small suppliers are perceived by buyers to be 'weak' and unable to meet the quality and delivery standards they demand. To help address this thesis, the study empirically explores why and how such large firms form inter-firm relationships, and whether this can lead to relationships with small firms as suppliers or partners. This latter objective involves the examination of the factors influencing inter-firm collaborative and competitive linkages in the Kenyan context.

#### **1.5 METHODOLOGY AND RESEARCH DESIGN**

Two reasons guided the methodology preference. First, the paucity of hypotheses about the motivations of inter-firm linkage behaviour, particularly in a developing country setting, made it necessary to generate information inductively. Secondly, due to time and resource pressures, it was necessary to limit the scope of the study.

The case study approach (which emphasises theory generation rather than theory testing) became appealing in exploring the transaction behaviour patterns of large firms and their use of inter-firm linkages. The case studies used are intended to reveal the hypotheses underlying the transaction (sourcing) behaviour of large firms in the Kenyan vehicle assembly industry. By first profiling the activities of the three motor vehicle assemblers and four of the twelve vehicle franchise holders in Kenya, it was possible to reveal the prevailing production organisation and transaction behaviour of the firms. 'Franchise holders' are those firms who contract the assemblers to assemble vehicles imported in the form of CKDs. It was considered prudent to use all of the three assemblers and their 'contractors', and little attempt was made to sample them, given the small number of cases in the population of interest. A more detailed discussion of the 'selection' process can be found in chapter six. Having identified the cases of interest, the Purchasing and/or the Materials Handling Officer(s) of each firm were interviewed to determine the nature and extent of sourcing behaviour. The firms' archival sources were also used to examine past behaviour, and to analyse changes in structure and size.

In the second phase, in-depth analyses of the motivations of large firms transaction behaviour were investigated using issues derived from the literature. The CEO or the Company Secretary was interviewed about the firm's strategic intentions, decisions, and motivations. Other members of the organisation were consulted periodically to obtain specific details of various activities and decisions.

### *Kenya's Motor Vehicle Assembly Industry*

To focus the study, a case study approach has been adopted. The vehicle assembly industry in Kenya was selected because of the investigator's familiarity with that country. Secondly, like many developing countries, Kenya exhibits typical characteristics suitable for flexible specialisation approaches (Schmitz, 1990), namely, a small and fragmented internal market for most manufactures; a poor supplier base for many products and services; and volatile demand structures in many industries. In addition, the country has recently begun the process of formerly developing subcontracting relationships between large and small businesses, giving priority to the Kenyan motor vehicle industry. The selection of the motor vehicle industry as a case study, therefore, provides an opportunity to explore the linkage strategy using some corresponding theory developed in other parts of the world, about relationships between large firms as buyers and small firms as suppliers or partners. It is hoped the at the findings of this research will inform strategies in other industries in Kenya, and other developing countries.

The general empirical approach to this study is sub-sectoral. Boomgard et al. (1992) argue that a sub-sector approach to SME development helps focus attention on the evolution of SMEs and

other firms by examining the characteristics of alternative competing channels, and the nature of the dynamic forces at work within and between channels. Gamser (1992), while supporting this approach for SME development, posits that sub-sector analysis uses schematic maps which summarise the economic relationships between small enterprises and other actors in the system, emphasising the vertical linkages, co-ordination between small firms and other actors, and the competition between these various actors. Hence, the motor vehicle industry was selected as the case sub-sector, because of the extensive collaborative and competitive linkages documented in this sector enabling useful comparisons with, development in other societies.

Three motor vehicle assemblers and four franchise holders have been used to explore the prospects for SME development through linkages with large firms. In the Kenyan motor vehicle assembly industry, only a few firms control the industry; there is a poor supplier base, offering only poor quality parts and services; there is a low and fragmented demand for vehicles; assemblers and importers have erected barriers to entry; because of an affiliation to principal manufacturers abroad, their corporate strategy demands quality and delivery standards which cannot be met by local small firms; and the technological requirements are constantly changing, and are expensive (Masai, 1991). Therefore, because of the nature of this task environment, firms in the Kenyan motor vehicle assembly industry are expected to:

- (i) pursue sourcing strategies which primarily assure them of access to resources, rather than purely efficiency and effectiveness objectives. On the other hand, it is expected that they will pursue various and multiple goals depending on their particular task environment regarding particular resources and particular markets.
- (ii) try to reduce uncertainty in their environment by internalising most activities unless they can control their suppliers, buyers, or technological changes. Consequently, they will try to increase their control over their business and competitive environments through negotiation, compliance, manipulation, or collaboration with the various pressure constituencies, particularly their suppliers and the government .
- (iii) For various reasons, mainly associated with market failure, they are likely to prefer suppliers other than local small firms.

Whereas these are not stated hypotheses to be tested in the study, they help to guide and focus it.

The results of the research have been addressed using descriptive and analytical approaches commonly used in qualitative studies such as that used.

## 1.6 STRUCTURE OF THE THESIS

This thesis is presented in nine chapters. In this first chapter, a broad overview of the study outlines the background of the thesis, and elaborates on the pertinent issues to be addressed. In chapter two, the logic for small enterprises is presented. This chapter highlights the role of SMEs in development, and explores the contribution of a linkage strategy between large and small firms to SME development. Chapter three reviews pertinent literature which might explain large firm - small firm linkages. This literature provides a loose frame within which to explore inter-firm relations between large and small firms. It explores the bases of inter-firm linkage formation, factors influencing a firm's sourcing behaviour, its structure and size, and its interorganisational relationships. Chapter four discusses some of the pertinent literature on inter-firm linkages in the motor vehicle industry. Chapter five reviews Kenya as the contextual setting of the study. This chapter suggests that the search for an SME development strategy in Kenya has been frustrated by the dominance of large firms and a simultaneous weakness of SMEs, and suggests that a strategy which links large and small firms is expedient.

Chapter six provides an account of the research design used, the case studies selected for the study, and also describes the research process. In chapter seven the results and findings of the three case studies present the large firms' profiles, outlining their transaction patterns, and discussing the motives behind a firm's Interorganisational Relations. In chapter eight, the results are analysed and discussed, and finally, chapter nine presents the conclusions of the study, suggesting their implications for policy, inter-firm relationships, outsourcing, and collaborative linkages. It also makes some recommendations for future action, and highlights the limitations of the study and suggests directions for future research.



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## CHAPTER TWO

### A RATIONALE FOR SMALL AND MEDIUM ENTERPRISE (SME)<sup>1</sup> DEVELOPMENT

#### 2.1 INTRODUCTION

The overall aim of this study is to contribute to the search for a strategy which could ameliorate the present poor economic performance in developing countries through a small enterprise development strategy. This research has suggested that one hitherto unexplored approach is the development of small enterprises through linkages with large firms. But why small enterprises?

Since the Bolton Report (1971) in the UK, the Birch study (1979) in the USA, and Piore and Sable's book (1984) in the USA, western economies have shown considerable interest in small firms as job generators, and in the latter case, as an alternative production organisation paradigm to mass production frequently blamed for poor economic performance. In Japan, and the South East Asian countries, small enterprises are seen as important in contributing to the general efficiency of industry. In developing countries, since the ILO Mission to Kenya (1972) small enterprises, particularly those in the informal sector, have been viewed as employment generators as well as agents of indigenisation of industry. Despite this variety of emphases, it remains evident that in almost all economies, small enterprises are considered important in one way or another. While evidence from European countries disputes their role as job generators, it acknowledges the possibility of an alternative explanation for their continued existence in almost all economies. The following discussion examines some of the 'explanations' offered in the literature for the persistent existence of small firms.

The chapter argues that the importance of SMEs lies, not in their role as ameliorator of the symptoms of poor economic performance, or as job generators, but as a logic which questions the validity of the choices regarding technology and production organisation in a given business

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<sup>1</sup>. In this research, this refers to definitions offered in various contexts, including enterprises employing 11-100 people (the case in many developing countries) and those employing upto 300 people such as in the Japanese case. In the particular case of Kenya, this includes those enterprises employing 11-100 people. This strategy has been adopted to avoid a protracted discussion on cut-off points for various sizes as this is beyond the scope of this thesis.

environment, and its implications for appropriate firm size and industry linkages. The internal logic of this study has been motivated by Schumacher's (1973) and Piore and Sabel's (1984) arguments regarding *appropriate* firm size (not small size *per se*), and their separate recommendations for nations to return to those technologies and sizes of firms which provide maximum well being for a country's citizens, striking a balance between these various sizes rather than exclusively emphasising one category:

Today, we suffer from an almost universal idolatry of giantism. It is therefore necessary to insist on the virtues of smallness - where this applies. (If there were a prevailing idolatry of smallness, irrespective of subject or purpose, one would have to try and exercise influence in the opposite direction.)

The question of scale might be put another way: what is needed in all these matters is to discriminate, to get things sorted out. For every activity, there is a certain appropriate scale ..... (Schumacher, 1973:54)

Re-thinking the philosophy and practice of mass production has both economic and political implications, particularly in developing countries where internal markets remain small and prospects for exporting are few, while the cost of large investments is likely to be high. Having inherited a Fordist paradigm of production from the west, whose main tenet is the logic of economies of scale, many of these countries have had little opportunity to take stock of the political and socio-economic implications of the large firms which have been created by embracing this paradigm, and their implications for dependency on foreign capital and western technology and inputs. In many developing countries, the role of SMEs seems to be that of a socio-political vehicle for developing an indigenous business class (Soon, 1983; Harper, 1984); utilising local resources and technologies as a vehicle of reducing technological and economic dependency (Harper, 1984); and improving the purchasing power of its internal markets through employment generation and resource re-distribution (Eg. GOK, 1986; Soon, 1983). Arguably, by developing SMEs, the apparent industrial disharmony emanating from the use of paradigms of mass production would be addressed, and technology choices harmonised with national development needs and objectives (Schmitz, 1990).

As many countries face economic decline, prolonged recession, high levels of unemployment and poor standards of living, SME development has increasingly gained importance as a strategy which could directly or indirectly ameliorate these conditions. Recent evidence suggests that SMEs have taken a variety of roles in these economies, exhibiting different levels of importance at different stages of development (Little, 1987), or in different industries. Considerable emphasis has been placed on the role of SMEs as engines of general economic development through new firm formation, contribution to value added or productivity of industries (Watanabe, 1972;

Friedman, 1988), or as an employment generator (Birch, 1979; Sengenberger and Loveman, 1987). In addition, while some observers have placed emphasis on the role of the SME sector in the generation, development and diffusion of technology to other firms and to consumers (Rothwell, 1989; Rothwell and Zegveld, 1982; Rothwell and Beesely, 1988), others have emphasised their importance in regional development and spatial reorganisation (Keeble and Wever, 1986; Storey, 1982; Storey and Johnson, 1987), or their social reorganisation capacity as income providers for large populations (GOK, 1986; Soon, 1983).

Evidently, varying emphases have been placed on SME development depending on their perceived importance, and the cultural perspective of particular countries. For Example, while Japan's industrialisation policies have traditionally given a central role to SMEs (Friedman, 1988), many developing countries have marginalised the sector, often relegating it to the peripheries of mainstream production systems, or designating it 'informal' (De Soto, 1989; Neck, 1977). Additionally, in some examples such as the US, SMEs are considered to be the cornerstone of a free market economy where there are few barriers to entry into business. Thus, in this case, socio-political support for SMEs has always been normal practice (Bannock, 1981). In developing countries, this marginalisation of the SME sector could be blamed on, *inter alia*, the lack of data which highlights the contribution of the sector to socio-economic development, and policy makers' lack of foresight about its importance. More recently, however, as governments learn from the experiences of some industrialised countries, evidence suggests there is increasing awareness of the value of a size distribution of industry to the general buoyancy of an economy, with small firms playing an increasingly more important role in socio-economic development (Eg. GOK, 1986; 1989; Malaysia, 1988).

The presence of SMEs in both industrialised and industrialising economies also questions the argument that the presence of SMEs should be seen in the context of the stage of development of a country - that the more industrialised a country, the lower the presence of SMEs (Little, 1987). Yet, many industrialised countries have moved towards the trend of smaller average establishment size, and have a high proportion of their production and employment in SMEs, and related SME activity. For example, in Japan, 20% of manufacturing is in establishments employing 9 or fewer people, and 38% in those employing 9-99 people (Friedman, 1988). In addition, 80% of the 49 million people employed in Japan in 1986 were working in small businesses (Sato, 1989). Other variants to this argument, suggest that the importance of SMEs varies from industry to industry according to the maturity of such an industry (Rothwell, 1989). According to this theory, less mature industries will be populated predominantly by small firms, while the mature ones in the same economy will be populated by larger firms. The cases of the electronics industries in Japan, Europe and America are considered mature industries, yet these have a balance of small and large firms. Hence, the industry maturity argument does not provide a complete explanation for the



resilience of small firms, particularly in developing countries where most industries are relatively immature, and yet are dominated by large firms.

The following sections discuss some of the documented rationales for SME development in developing and developed economies.

## **2.2 THE ROLE OF SMES**

While the role of SMEs in developed economies focuses on their economic contribution, in industrialising economies the focus is on their socio-political role.

### **2.2.1 THE ROLE OF SMES IN INDUSTRIALISED ECONOMIES**

The focus of SME development in industrialised countries appears to have been specifically geared towards economic regeneration and employment creation. However, in addition to this intended role, various studies have shown other roles which the sector plays in economic development. The following are some of the major rationales which have been advanced for the development of SMEs in the industrialised countries of Europe, America, and Japan. Apart from providing the context within which entrepreneurship has been studied, SMEs have been said to make economic contributions to national output as generators of new growth; and employment; technological innovation, adoption and diffusion of innovations, and their impact in industrialisation; their contribution in regional development, and the re-distribution of resources in deprived areas. As mentioned already, SMEs mean various things to various groups, thus their net value to development is likely to be controversial. However, even where their contribution to economic development has been questioned, as in the case of their employment creation ability, the continued interest in the sector suggests other underlying social and economic benefits. The following sections briefly discuss these rationales.

#### ***SMEs in New Growth and Contribution to Output***

Pressured by the urgency to improve economic performance and to generate employment, much of the political and intellectual interest in the value of SMEs to economic development has been in terms of their contribution to new growth, value added or their contribution to industrial productivity. In the UK, for example, the Bolton Commission envisaged SMEs as the answer to a depressed economy and to curbing unemployment (Bolton, 1971). Since this report, various studies have shown that whereas small firms can be traced in national industrial statistics, their actual contribution to employment, output or value added is small compared to that contributed by large firms. Much of this analysis is based on the measurement of the contribution of the sector as

an isolated entity, hence, its reported contribution to output, employment or value added, has not been encouraging.

Conversely, in Japan, where the value of SMEs has always been measured in terms of inter-firm productivity rather than by its absolute contribution to the economy as a separate sector (Minato, 1992; Sato, 1989), SMEs are regarded more positively. More specifically, Watanabe (1972) argues that the contribution of SMEs to national output cannot be sufficiently assessed purely quantitatively, but by their linkages with high volume large firms - through subcontracting activities. Thus, he concludes, the efficient use of small enterprises in Japan has been closely linked to subcontracting. In 1966, 310,000 enterprises (53.6% of all medium and small enterprises in Japanese manufacturing) were subcontractors, and they employed 3.6 million workers, more than one quarter of the total manufacturing labour force.

### *SMEs in Employment Creation*

Although policies and strategies had already been formulated for the development of SMEs in many countries before this report, Birch's (1979) seminal study of employment in the manufacturing and private sector service establishments in the United States was, perhaps, the impetus for interest in SMEs as a vehicle for job generation. The revelation that about 82%<sup>2</sup> of all new jobs created, and 66% of the net increase in employment in the USA between 1969 and 1976 were in small firms, led to a resurgence of interest in SMEs in the United States and also in other economies throughout the world. These results have been controversial. Others retesting the America data (Eg. Evans, 1987) found different results, while the UK data (Gallagher and Stewart, 1984; Doyle and Gallagher, 1987; Storey and Johnson (1987), confirmed previous results, but claimed that the actual rate stated by Birch was overestimated. Gallagher, Daly and Thomason (1990) in more recent work, also concluded that almost all of the new job growth in the UK between 1985 and 1987 was in businesses employing fewer than 20 people. Some studies have disputed the argument that SMEs have a capacity to generate employment. Gould and Keeble (1984) note that in the East Anglia region (UK), new independent manufacturing firms set up between 1971 and 1981, and surviving upto 1981 employed, on average, 12 workers each, and accounted for 4.7% of total 1981 regional manufacturing employment.

In the UK, this criticism of the 'over-glorification' of the SME sector suggests that rather than generating entirely new employment opportunities, the sector has simply absorbed employment

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<sup>2</sup>. Figures by Amington and Odle (1982) which use the same data revealed that 39% in 1979-1980 period and 53% in the 1975-1982 period. In addition, Fothergill and Gudgin (1979) repeated this study in the UK but reported that these figures were overestimated.

being shed by the large firms as they rationalise their activities (Sengenberger and Loveman, 1987), and that there are no prospects for new employment generation in the short run (Keeble and Wever 1986).

Although these negative judgements against SMEs seem harsh, their value should be seen in their capacity to re-orient the analysis of the SME sector. For example, it can be argued that it is perhaps the absorptive capacity, manifest in the absorption of labour shed by large firms during recessionary periods, that has contributed to the resilience of the SME sector in some industrialised economies; or that the SME sector can be important in total industry efficiency, even when actual contribution to employment is limited.

### *SMEs in Productivity and Return on Investment*

Productivity and profitability based arguments for SME development (Pratten, 1991) adopt the principles of traditional economic models, suggesting that the advantage of SMEs lies in their lower unit cost, relative to that of the large firm. They argue that the cost saving advantage of SMEs results from their lower overheads and lower labour costs relative to those of the large firm, and that because of this, SMEs are expected to enter market niches that are too small to be profitable for the large firms which are sensitive to economies of scale. It further argues that because SMEs tend to be more labour intensive, and labour costs are currently generally lower than capital costs in most economies, their relative investment level is lower. Recent evidence indicates that this argument is no longer valid as the importance of fixed costs has decreased (Kleijweg and Thurik, 1991), and therefore, by adopting flexible production methods, where large firms can access larger and wider markets through subcontracting, they can compete in market niches just like the small firms.

### *SMEs in Technological Innovation, Adoption and Diffusion*

Rothwell and Zegveld (1982) have argued that SMEs are important in technological innovation, as well as the adoption and diffusion of such technology as small firms search for cheaper ways to produce goods and services. Theoretically, it would be expected that because of their size, their limited access to resources, and their immediate objectives to survive, these firms are less likely to invest in R&D. However, equally likely is the possibility that in an effort to produce efficiently, they use technologies and processes that are innovative in their own right. Hence, SMEs have continued to contribute to technological innovation and diffusion.

Basing their observation and argument on the logic of the Schumpeterian entrepreneur, Castells (1984) and Saxenian (1985) suggest that the importance of SMEs in the technological advancement of newly emerging industries has become apparent, particularly in R&D activity.

These authors argue that owing to their owners' natural curiosity, and the relatively small scale of operation of their enterprises, SMEs are willing to try out new technologies. They argue further, that since the entrepreneur's personal objectives are closely associated with those of the firm, he/she is instrumental in finding new ways of production. This scenario explains the continuing interest in technology based firms as possible regenerators of economic growth. They are not only capable of providing a stock of entrepreneurs, but also a stock of new technology.

However, Aydalot (1988) suggests that SMEs will vary in importance in different sectors, implying industry specific explanations for variations in the importance of SMEs, depending on:-

- (a) the technical progress in that sector. The less technologically advanced, the more important the SMEs and vice versa.
- (b) the technological niches available to the small enterprises which depends on the homogeneity of products, the ease with which existing technologies can be adapted, and the flexibility of demand patterns.

Hence, it is reasonable to expect varying emphases on the technical and technological contribution of SMEs in different industries. Technology-based small firms exist in almost all industrial situations but will differ in the relative centrality of the role they play, many of them playing a complementary role to large firms through strategic partnerships and technical consultancies (Cooke, 1988).

On a second level, the importance of SMEs is said to lie in their agency of adoption and diffusion of innovations. Rothwell and Zegveld (1982) and Rothwell (1989) propose that SMEs are used as agents of implementation of technologies developed by the busy R&D departments of large organisations which may not have the time nor the economic incentive to exploit all of their innovations. To extend this relationship, through activities such as technology acquisitions, the large firms buy back these technologies once they have been tested and 'legitimised' in the smaller companies (Rothwell and Beesely, 1988). These relationships are gaining importance as firms collaborate to exploit technologies and markets. It has also been suggested that SMEs are also likely to be better agents of diffusion of technologies within industries. While studying firms in the Paris region, Decoster and Tabaries (1986) found that personal contact rather than industrial links were important in the spread of innovations in industry. They went further to suggest that because small firms relate more on interpersonal levels, innovations would be adopted and diffused at a faster rate, particularly in the early stages of product and process development (Rothwell and Zegveld, 1982).



Finally, it has been suggested that technologies and personnel used in the large firms are largely incubated in SMEs. Recent research work on technical consultancies and other forms of technology-based small firms suggest that, increasingly, small firms are providing large firms with proven technologies, and trained personnel through technological consultancy (Jones-Evans and Kirby, 1992).

### *SMEs in Regional Development*

The role of SMEs in regional development has been articulated mainly by geographers in terms of their spatial and temporal implication for regional economic balance (Keeble and Wever, 1986; Storey and Johnson, 1987; Keeble, 1990). This body of literature suggests that this imbalance is possibly the result of historical, political, and natural factors, and the effects of the emergent industrial structure. Although they raise essentially socio-political questions of resource distribution and regional balance, these researchers use the geographical concepts of spatial agglomeration, and its effect on industrial location, to suggest that because inter-industry dependence offers markets, infrastructure and institutional support in a variety of relationships, firms will locate where they can find services, infrastructure and demand. Finding a deficiency in the services of certain regions means, according to them, that firms will not locate in such areas. However, this thesis has become increasingly questionable as increasing spatial separation of the various stages of production, conception of ideas, skilled production, and routinised production, give enterprises opportunities to choose production sites that are most suited to their needs. In addition, because of innovations in information technologies (Gershuny and Miles, 1983) inter regional transactions are possible, particularly in industrialised countries. Therefore the agglomeration thesis and the concepts of 'hub' centres and 'poles'<sup>3</sup> stand to question.

Despite these arguments, the extent of SME effect on regional development has various explanations. On the one hand, Aydalot (1988) has hypothesised an association between the structure of the local milieu with firm size in France, proposing that areas dominated by small firms experience faster development and have a high firm birth rate, but those based on large enterprises undergo sluggish employment rates and a lower rate of new venture formation. Citing the work of O'Farrel (1986) and Illeris, (1986), he suggests further, that the establishment of small firms may be closely related to the number of existing firms, and that possibly associated with other psycho-social and economic factors, the children of business owners are more likely to establish businesses themselves. On the other hand, where an employee culture prevails, there is likely to be less competitiveness and therefore less entrepreneurial activity. Given this contextual role, regional SME development has been the pre-occupation of the political and intellectual

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<sup>3</sup>. See Perroux (1970) for an account of the Growth Pole Theory.



promoters of the sector (Keeble and Wever, 1986). However, it is the contribution of the sector to general regional growth which is important. Contribution to output for regional and export markets; employment (Keeble, 1990); and technological progress of such regions (Rothwell and Beesely, 1988) have constituted the main areas of interest in this sector.

### **2.2.2 THE ROLE OF SMEs IN DEVELOPING COUNTRIES**

Since the ILO mission to Kenya in 1972, SME development in developing countries has become an important vehicle for economic development, particularly as a vehicle for employment generation. Yet, despite the lessons to be learnt from the experiences of western and South East Asian countries, many developing countries have not developed specific SME policies. One of the explanations could be the historical legacy of colonialism, and the effects of the institutions and structures which were used to support it. Developing countries have to examine their past experiences in order to formulate strategies which avoid mistakes made in the past, or those which attempt to ameliorate the effects of such errors. Piore and Sabel (1984) claim that as

"The more we understand of our past and present, the more we see that it is our choices that shaped our history and will shape our future." (p307)

It is precisely this realisation that has led industrialised countries to re-orient their productive organisation as the choice of mass production organisation has not been altogether fruitful (Womack et. al., 1990). They have since begun to move towards more flexible technologies and fragmented productive organisation. Yet, many developing countries continue to pursue productive organisation paradigms currently considered to be burdensome to an economy.

Although the role of SMEs, or Small Scale Enterprises (SSEs) as they are known in many developing countries, does not differ significantly from the experiences of the industrialised economies, they have more prominent socio-political implications in developing economies, for example as a vehicle for job creation. Hence, the political rather than the economic roles have been emphasised in such countries. The envisaged role of SMEs has been, for some countries, that of a political tool to achieve economic independence from the west through indigenisation of economies (GOK, 1965; 1986; Malaysia, 1971, 1991), while other countries see the sector as a tool for social re-adjustment through resource re-distribution among various regions, races and classes, and poverty alleviation (Malaysia, 1991). In Peru, and perhaps many other developing economies, SMEs have increasingly taken the role of a vehicle for democratic change in the economy, primarily as a means of supplanting the elite capitalist class and transferring power to more people in the economy. (De Soto, 1989).

Yet, in many of these countries, SMEs have, until recently, been regarded as peripheral to mainstream production systems (the black economy). Consequently, they were not properly integrated into the capitalist mode of production, being regarded as residual (and labelled micro- or 'informal') in present industrial structures, implying a kind of superiority of performance of the large firm, presumed to have 'efficiency' advantages. This view has been reinforced by traditional economic theories based on the concept of economies of scale, assuming the higher relative productivity of large firms. The attraction of measures such as these is their suggestion that since large firms tend to be more capitalised, and have a higher output per unit of capital employed, they are likely to have a higher productivity. However, countries which embrace this perspective fail to recognise (perhaps for political rather than economic reasons) that the advantage is likely to be cancelled out by the higher fixed cost levels of the large firm, and the higher wages which increase with size either because more skilled labour is required, or higher maintenance requirements necessitate an increase in manpower. Therefore, the smaller firm is more likely to survive at its lower productivity level, mainly because of lower wage and capitalisation levels; and also because owners are more likely to be willing to accept lower profits. A contrary position is maintained by Liedholm and Mead (1987) who used a benefit-cost analysis to compare the relative efficiency of small and large industries in Sierra Leone and found that in all the key individual industrial groups examined, the social benefit-cost ratios of the small firms not only exceed one, but are also greater than the comparable ratios for the large-scale firms.

The rationale for having large scale firms in the economy has also been queried in view of the development stages which many developing countries are at, and the demands that large scale production organisation makes on the socio-economic structure of the country concerned (Kaplinsky, 1978; Schmitz, 1990). To reinforce this criticism, Todaro (1982) cites the shortage of capital for large scale projects in such countries as one reason why they should not be promoted exclusively, adding that such projects do not lend themselves to widespread replication, rendering small scale projects more relevant in the generation and diffusion of appropriate technologies in these countries. In addition, small scale projects may be a more cost effective way of importing technologies into the economies of developing countries through subcontracting relationships with foreign and local firms which have the capacity to import technology. Further, by implementing technology on a small scale, and assessing its efficacy, developing countries are likely to avoid the expensive importation of inappropriate technologies. White (1976), Nyong'o (1988) and Coughlin (1988) point to the large number of failed projects in developing countries, citing the inappropriateness of technology as one of the prime factors contributing to this failure. Yet, large firms have continued to exist, and even dominate the economies of many developing countries (ILO, 1986).

The following are some documented roles of SMEs (or SSEs)<sup>4</sup> in developing countries.

### *SMEs in Employment*

The greatest interest in the SME sector in developing countries has been in their envisaged ability to provide employment to their large populations, particularly to the poor and marginal groups, by providing rural and urban self-employment and, to a limited extent, wage employment (ILO, 1986). This report indicated that in Nigeria 20%, Sierra Leone 11%, Afghanistan 16% and the Republic of Korea 26%, of rural males were engaged in secondary employment in the SSE sector (covering very small enterprises employing 0-5 people), in order to supplement their income. In a different survey Liedholm and Mead (1986) report that the share of manufacturing employment of all firms engaging 10-49 people was 63% in Nigeria (1972); 6% in Zambia (1985); 26% in Thailand (1978); 25% Honduras (1979); and 12% in Kenya (1984). In Kenya, the sector employs between 40% and 60% of the urban labour force, and contributes between one quarter and one third of total urban incomes. With particular reference to Kenya, while accepting that SSEs in the developing countries context do not necessarily aim to maximise profit, the Kenya government adopts the strategy mainly to create employment for school leavers within family businesses. However, as can be expected, much of this employment is marginal in the sense that it is in those sectors with minimal value added such as retailing, and is evident in underemployment both in the rural and urban areas. Secondly, measurement of the true contribution of the sector to employment has been problematic. The accuracy of records in the sector is affected by the marginalisation of small enterprises through legal restrictions which have driven them into the 'black' economy,<sup>5</sup> and hence, have not been registered (De Soto, 1989). Despite this initial negative attitude, many industrialising governments began to recognise the sector in the 1980s, and began to plan for it (Eg GOK, 1986).<sup>6</sup>

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<sup>4</sup>. It must be noted here that the term Small Scale Enterprises (SSE) is used more in the developing country context because of the wide range of definitions of the size of small and medium firms. While some firms are very small, offering only self employment prospects, others are within the descriptive range of the definitions adopted for formal small firms in industrialised countries - employing up to 300 people (For the Japanese definition see Sato, 1989). More often, the upper limit for support within the sector is 50 employees. The support agencies use the term SSEs or SMEs interchangeably, but tend to lean towards the SSE description.

<sup>5</sup>. This refers to the parallel economy which has evolved in many developing countries, often labelled 'illegal' by government officials. In some countries such as Peru, it has been the basis of the informal enterprise sector (De Soto, 1989).

<sup>6</sup>. Kenya embarked on such a programme in 1986 - The *Small Scale Enterprise Development Programme*, as a joint venture with UNDP and ILO. The process of developing an SSE development programme commenced in 1987.

An interesting approach to employment creation is the socio-political dimension presented by Weiss (1988) and others, that the rationale for supporting small firms is its socio-political role in maintaining social order by preventing unemployment. Small firms act as a 'shock absorber' for the modern economy - absorbing or releasing labour as the economic cycle demands (Berger, 1980), which implies that the large scale firms have a low absorptive capacity. Politicians have continued to promote the development of small firms because unemployment is 'the most serious problem susceptible to radicalism' and that this sector protects society from unrest and explosions (Weiss, 1988:28). From another angle, Pizzomo (1960) is cited by Weiss as proposing that small firms are used to create employment as a vehicle for the management of consensus. By this is meant the need to carry favour with particular parts of the community, in this case, small employers and the workers they hire. However, this thesis is not elaborated.

### *SMEs in National output and productivity*

The contribution of the SME sector to the economies of developing countries is mainly emphasised in manufacturing. For example, ILO statistics show that in 1982, SSEs made up 95% of all registered enterprises in the manufacturing sector of developing countries (ILO, 1982). Writing about countries of South East Asia, Soon (1983) stated that in Indonesia, 99.5% of all manufacturing is either small or handicraft industries, while in Singapore, the population of SSEs is about 97% of all manufacturing firms. The population of SSEs is not as high as this in other parts of the developing world. For example, in 1980, SSEs accounted for 29.6% of manufacturing in Brazil; while in Indonesia and Sierra Leone in 1974/75 SSEs accounted for 20% and 44% of manufacturing respectively (ILO, 1986).

The importance of SMEs to large firms in manufacturing is well documented, albeit more prominently about South East Asian than African countries. In his work, Anderson (1982) reported that employment expansion of large firms attributed to the growth of small firms ranged between 40% and 53% for Korea, the Philippines, Turkey and Taiwan; and 67% and 70% for India and Columbia respectively, achieved mainly through subcontracting relationships like the 'putting out' system, a form of sub-contracting. It is possible that these figures are even higher, since it is difficult to measure the subcontracting activity in many developing countries, owing to the 'informality' of the SSE sector. It is also made difficult by the lack of a clear definition of the full extent of the varieties and impact of sub-contracting. It is likely that varieties of 'home work' systems and other tiers of subcontracting in any transaction with a large firm exist. In other developing countries assessment of the contribution of SMEs in real economic terms has been problematic due to a dearth of data from these countries, either because of the 'informality' of these businesses, or because of a deliberate marginalisation of the sector by Government agents (ILO, 1986).



### ***SMEs and Return on Investment***

It has been proposed that the value of SMEs in developing countries is their relatively lower cost per job created (World Bank, 1978) derived from their relative capital intensity (White, 1976); and use of recycled, local resources, thus less likely to have burdensome implications for foreign exchange reserves (Child, 1977; Harper, 1984). For example, Aboagye (1986) has calculated that the capital cost per worker employed in small firms in the developing countries of Africa is US\$210 and US\$22,000 in the formal manufacturing sector. Harper (1984) adds that in developing countries SMEs provide low cost substitutes of imported goods to the rural and urban poor, by using local and recycled materials. He also suggests that, because they are widely dispersed in the rural areas, they allow for widespread distribution of products and services thereby introducing relatively higher standards of living in the remote rural areas of some countries. All of these arguments have had appeal for policy makers in these countries as they were seen as capable of achieving the triple barrelled role of bringing development and employment to the urban and rural poor, while conserving the limited foreign exchange reserves in the country (ILO, 1972; Neck, 1977; GOK, 1989). Although this rationale is advanced mainly in relation to micro-enterprises, it can be extended to more sophisticated levels, and to larger organisations as the rural populations progressively achieve a higher standard of living. It may also be argued that because SMEs can play the role of introducing technologies into an economy, they form a sufficient basis for the development of infrastructure and institutions to deal with higher levels of development at a later stage.

### ***Resource Redistribution and Restructuring of Business Ownership***

The importance of SMEs in regional development is relevant in the developing countries on two levels. First, that the developing countries as a region within the global economic order have been, for various reasons, treated as a peripheral component of the global economy, thus remaining on the margins of global economic growth. Secondly, within developing countries, there are regional disparities which arise mainly from historical factors, and which have been perpetuated by various social and economic institutions. Because regional development in these economies is closely linked to national unity, the political strategy is to re-dress the racial/tribal question inherent in regional demarcation (GOK, 1986).

Many developing countries have, therefore, continued to envisage SMEs as a political vehicle for reduction of resource dependency, and as an agent of regional, tribal or racial balance (Malaysia, 1991; GOK, 1965, 1986; 1989). Because of the politics of resource ownership in capitalist systems, business ownership reflects access to resources and subsequent economic power. Because SMEs offer alternative employment, they offer the means to acquire other factors of production,



thus creating a petty bourgeoisie class which has a capacity to accumulate and invest, and gradually build a power base. In this sense, the SME sector can be seen as a vehicle for the re-distribution of economic power. This income equality thesis should, however, be treated with caution. It can be argued that it is precisely due to the fact that a petty bourgeoisie class is formed, and through a series of barriers erected by them to protect their position, that the prevailing status quo is maintained. For example, the gap between the poor and the rich still grows in the developing countries (World Bank, 1989).

On a more global level, SMEs are seen as addressing the dependency of developing nations on the industrialised west, by addressing the issues of import substitution, and indigenous resource accumulation. The power relations between the industrialised and developing countries are, therefore, likely to be significantly altered by the development of strong local economies. Surprisingly, one of the arguments against the development of SMEs has been that this perpetuates the dependency of the developing countries by confining their development activities to marginal forms of capital accumulation like SMEs and micro- enterprises. The weakness of such an argument is that it does not take into consideration the impact of over-dependence on large firms, and on mass production technologies.

### 2.2.3 SUMMARY

Clearly, the role of SMEs varies according to the development objectives of various economies and from industry to industry. It is also clear that the net contribution of the sector to these various economies has not been as impressive as was envisaged, possibly due to the way the contribution of the sector has been measured - in isolation rather than as a part of a complete industrial system. However, the persistence of the SMEs in many of these economies suggest other benefits of the sector. This thesis argues that to realise the full benefit of SMEs, their contribution must be assessed within a composite industry framework rather than in isolation, and in relation to their relationship with large firms. Hence, decentralised work organisation is an alternative to mass production paradigms which have tended to promote vertical integration, and the continued isolation and/or elimination of small firms. Because the current industrial structure favours large firms in most countries, this strategy calls for post-Fordist production approaches. In many industrialised countries firms are already making strategic choices away from this paradigm as the importance of fixed costs diminishes (Kleijweg and Thurik, 1991), and increasingly, large firms are seeking complementarity with small firms (Olleros and McDonald, 1983). Given their demand and technological environments, it is even more important for developing countries to move away from mass production paradigms towards small batch, more flexible technologies, and a more balanced size distribution of industry as part of their political strategy to improve economic performance.

The next section explores the Post-Fordist (flexible specialisation) paradigm and its implications for productive organisation.

### **2.3 THE FLEXIBLE SPECIALISATION PARADIGM: IMPLICATIONS FOR SME DEVELOPMENT**

The post-Fordist paradigm, advocating flexible productive organisation, not only provides the paradigmatic logic for SME development, but also provides a framework for production decentralisation, and re-organisation. Before proceeding with this discussion, it must be noted that although the literature makes important distinctions between 'post-fordism', flexible specialisation, and lean production, this thesis is interested in the underlying phenomena of de-aggregation present in all of these forms of production organisation. The growing literature emanating from Europe, America and Japan indicates that in practice, there is no single route to flexible specialisation, neither does it always lead to the use of small scale firms during the process of de-aggregation. For example, there are large scale variants of flexible specialisation (northern Germany and UK retailing), and small scale variants (Southern Germany and the Third Italy). In addition, production flexibility can be achieved within a plant that adopts mass production techniques (Nissan automotive plant in the UK). Consequently, throughout this thesis, the use of these terms will infer the underlying logic of de-aggregation, and the potential for using 'outside' suppliers of inputs.

The preceding section suggested that the importance of SMEs is likely to be based on their complementarity with large firms in a composite industrial structure, a role which can only be realised if and when the Fordist paradigm of productive organisation becomes less dominant. This implies work decentralisation, fragmentation of large firms, and a shift from internal to external markets. In the resulting work re-organisation as firms attempt to accommodate the demands of the new productive organisation, networks and clusters of firms emerge, based on a variety of relationships between large and small firms, and also among the SMEs themselves. This section discusses the implications of these developments for SME development.

#### **2.3.1 FLEXIBLE SPECIALISATION AND PRODUCTIVE ORGANISATION**

The 'Flexible specialisation paradigm' is viewed as an alternative capital accumulation paradigm to mass production, aimed mainly at production restructuring. Its main focus is the 'flexibility' introduced into the production processes of organisation. This paradigm has been controversial. Its critics doubt its ability to restructure an economy significantly (Pollert, 1988). However, three aspects of the logic underpinning it, are relevant for SME development: (i) while questioning the

paradigm of mass production,<sup>7</sup> this paradigm (ii) supports small-batch production organisation, flexible production regimes, and (iii) a size distribution of labour in industry. Thus, the movement away from mass production to customised, small-batch production organisation provides a framework within which to analyse alternative approaches to small enterprise development, particularly in an environment where large firms predominate, and internal markets are too small and/or fragmented to support mass production. Several proposals inherent in this paradigm are pertinent for this study. First, by suggesting the downsizing of large firms, industries can be de-concentrated, allowing more firms to compete in the same markets (Howells, 1989). Secondly, SMEs can enter markets hitherto dominated by large firms. Thirdly, by suggesting flexible integration where firms form networks, wider markets can be reached by all parties concerned. Finally, through networks, SMEs can jointly achieve economies of scale, if these are important in their industries. This study bases its analytical underpinnings on the paradigm's emphases on flexible work organisation, external input and process sourcing, clustering and networking of suppliers, market segmentation and vertical disintegration of enterprises (Best, 1990; Schmitz, 1990).

Secondly, the Japanese (Watanabe, 1972; Sato, 1989), Italian (Becattini, 1990, Brusco, 1986) and German (Schmitz, 1992) experiences suggest that there is a complementarity between large and small firms regarding scales of production, generation and diffusion of innovations, and productive networking. In Japan, for example, the emphasis is not so much on downsizing large firms, as it is on linking small firms with large firms, as subcontractors (Friedmann, 1988). In Italy, on the other hand, complementarity is defined within the framework of SME networks which supply the large firms collectively, or have entered markets hitherto dominated by large firms (Becattini, 1990). In hypothesising how this occurs, Howells (1989) proposes that explanations are likely to be found within large firms, since the changes which are taking place in the size distribution of production in the UK and other economies is itself a function of strategic decisions and structural changes inside existing large firms as they adjust to a volatile and uncertain environment. At the operational level, large firms have responded by production decentralisation<sup>8</sup> and structural dis-

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<sup>7</sup>. Although this explanation of flexible specialisation takes the perspective of moving away from mass production, it must be noted that aspects of flexible specialisation, for example, flexible production schedules and related strategies of JIT delivery systems, can be found in firms which adopt this approach to production organisation. In the Nissan automobile plant in the UK for example, JIT procurement systems co-exist with robotised assembly, producing using mass production approaches.

<sup>8</sup>. Decentralisation is used to mean the allocation of production capacity to units outside the ownership structure of the firm, rather than in its conventional sense of decentralising the activities of the firm within one ownership structure.

aggregation and de-integration (Mead, 1984) as tools for competitiveness, resulting in more flexible, leaner and flatter organisational structures, using external transactions and inter-firm linkages (Harrigan, 1985). On one level, the internal efficiency of the downsizing of large firm is expected to produce efficiency. On another level, through integrated networks of suppliers and distributors, such firms can, arguably, access a wider range of inputs and markets. This theme has been taken up by contemporary management strategists such as Kanter (1989) as the "competitive tool of the 90s and beyond".

Thirdly, this paradigm further argues that instead of seeking internal economies of scale, it is the external economies (of scale and scope) which are likely to lead firms to competitiveness. Hence, in a combination of contract and quasi-integrated arrangements (flexible production organisation), firms can cover wide markets, and also compete in market niches. At the same time, these flexible arrangements allow a firm to increase capacity, for example through capacity subcontracting, licensing and franchising, without necessarily altering their investment base or production activities in response to fluctuations in demand. It is also possible to obtain specialist capacity from external sources while concentrating on core activities (Lorenzoni and Ormati, 1988; van Kooij, 1990; Harrigan and Newman, 1990). The resulting production decentralisation becomes important for SME development.

Finally, an interesting perspective of the role of small firms is stimulated by Weiss (1988) who contends that "states, not markets *per se*, have generalised the impulse to scale and concentration". She further charges that the state has used concentration of industry to manage inter-state economic and military competition, thus eliminating small undertakings. This scenario is familiar in developing countries where industrial policies are used for geo-political positioning, and small firms might be seen as a weakening of the concentration of international political power by weakening the industrial base.

### 2.3.2 PRODUCTION DECENTRALISATION AND SME DEVELOPMENT

The preceding section has suggested that flexible specialisation provides a rationale for work decentralisation. Three concepts issuing out of work decentralisation are pertinent for SME

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<sup>9</sup>. Although Williamson's theory was originally formulated in terms of production costs, he also argued that asset specificity and demand uncertainty are joint conditions for a decision to make a product in-house. In other words, the transaction cost theory covers other costs such as those involved in searching for sources of supply and information, as well as the costs of monitoring and enforcing contractual performance. The 'cost' concept can be widened to include, for example, the loss of market share which arises from the extended innovation cycles which may be 'thought' to have arisen through externalisation.



development: large firms are likely to externalise activities (externalisation); fragment structurally; and use external rather than internal markets, leading to external transaction, possibly with SMEs. Thus, while large firms move away from traditional mass production organisation, they are expected to use, simultaneously, disintegrated organisation structures and external market transactions to procure inputs. Thus, prospects for SME development lie in (1) the opportunities opened for new entrants by externalising firms (Howells, 1989), and (2) the ensuing linkages with firms seeking from external markets, those activities which they no longer provide in-house.

### *Externalisation of Activities*

When they downsize to achieve competitiveness, large firms meet their requirements by outsourcing. Howells' (1989) definition of the term 'externalisation' implies that activities are shifted from within the firm to outside it. Yet, it is all of those activities which could potentially be undertaken in-house, rather than only those that are being shifted, which are of interest to small enterprise development. Thus, as used in this study, externalisation is the use of market transaction to expand capacity or to procure inputs and dispose of outputs in a potentially internal market system, to include activities such as licensing, franchising, and capacity sub-contracting.

By definition, therefore, all the activities of firms can be externalised since, according to Gibb (1993:6), "most large firms are conglomerations of services, processes, component production and subassemblies, many of which could be run independently". However, whether these activities are procured on the external or internal markets depends on the implication of external sourcing to the relative power position of the externalising firm within its competitive environment. This study proposes that firms are more concerned with their competitive position regarding markets and inputs, and will choose the relevant structures and size, which enables them to achieve and retain this position. They are, for example, concerned about access to and control of resources as a critical component of competitiveness (Porter, 1980).

### *Structural Fragmentation*

The importance of vertical integration is linked to the principles of economies of scale supporting the logic of mass production. Its underpinnings can be found in the logic of resource allocation first proposed by Coase (1937), arguing that firms and markets are alternative methods of co-ordinating resource allocation - transaction, and that internal markets are used where external markets cannot allocate resources in a manner which alleviates uncertainty (Williamson, 1971, 1975). Vertical integration therefore becomes necessary as a means of avoiding search, negotiation, and regulatory costs (Coase, 1937) especially where stable supplies of resources are crucial. Consequently, firms move into businesses which are different from their strategic core activities through lateral and horizontal integration, sometimes even when such intra-firm transfers



do not make economic sense (Harrigan, 1985), but have implications for their relative bargaining power, or are strategic moves. For example, in many developing countries, the uncertainty of resource availability has led many firms to hold excess capacity as an insurance against production stoppage (ILO, 1986).

As has been stated, by shifting transactions from internal to external markets (Sabel, 1982; Piore and Sabel, 1984), flexible specialisation has implications for the firm's production organisation (markets) and its organisational development strategies. The external markets used during externalisation necessarily shift the organisation from a vertically integrated structure to a decentralised 'quasi-integrated' one, governed by market transactions (Harrigan, 1984). Vertical disintegration is, therefore, a firm's strategic approach, not only to achieve productive efficiency, but also to become adaptable by being flexible.

Also important for SME development is the ownership change resulting from the fragmentation process. Shutt and Whittington (1986) and Howells and Green (1987) delineate three possible ownership outcomes of external transaction where: activities are decentralised to a subsidiary or associate company while retaining ownership; devolved to separate, autonomous enterprises via license or franchise agreements; or the firm uses market transactions and disintegrates into separate, autonomous enterprises, where no ownership links are maintained (Perry, 1992). It is the properties of devolution and disintegration which have prospects for small enterprise development.

### *External Markets and External Transaction Behaviour*

The third aspect of production decentralisation pertinent to this discussion is the way firms transact - the actual transaction behaviour resulting from their strategic positioning choices. According to Williamson (1975), internal markets (firms) exist because of asset specificity and the existence of frequent internal demand. Hence, traditional management models, underpinned by the importance of economies of scale, assume that managerial decisions are made to retain these internal markets, minimise costs and maximise profits. A firm will be expected, therefore, to seek to minimise all costs with minimal loss of control over transactions since, loss of control has implications for bargaining power positions with relevant pressure constituencies. Assuming that the firm is a rational price taker motivated by cost efficiency, it will use internal markets if the costs related to

external markets, particularly transaction costs,<sup>9</sup> are higher. However, as Harrigan (1984) has argued, other reasons exist for short-term transaction behaviour. Although profit assures a firm's survival, relative bargaining power in its environment is more important. Thus the long-term strategic positioning needs (the organisational vision), based on the perceived certainty or uncertainty surrounding markets and technologies; and the power relations in bargaining with clients, suppliers, markets, and other constituencies (Harrigan, 1984) will influence immediate transaction behaviour. The firm will then adjust its internal systems, or change the environment through collaboration (Hirsch, 1975) and negotiation in order to achieve more favourable positions with the pressure constituencies. In seeking competitiveness, therefore, firms will weigh efficiency (cost) against control implications.

### 2.3.3 Production Re-organisation and SME Development

Adoption of the flexible specialisation paradigm proposes that production re-organisation will result from externalisation and structural fragmentation, achieved through subcontracting, licensing, and various kinds of strategic collaborations.

#### *Subcontracting*

Subcontracting is the most frequently used form of outsourcing. Historically, its origins can be traced to the industrial revolution in Europe where the 'putting out' system was used periodically to smooth production (Landes, 1966). Despite initially being treated as ephemeral, marginal and dated (Shutt and Whittington, 1986), its role in the regeneration of the Japanese economy has made it one of the most prominent productivity strategies in the 1990s in Europe (Friedman, 1988; Turnbull et. al., 1992).

Subcontracting permits organisations to outsource in order to smooth production (Kamien and Li, 1990); obtain resources which they cannot access internally for various reasons (Chaillou, 1977; van Kooij, 1990 Watanabe, 1971; 1972); and expand their markets through external distribution networks (Watanabe, 1972) and product differentiation (Best, 1990). The literature highlights three main types of sub-contracting based on the rationale for using the strategy: (i) economic subcontracting, motivated by cost minimisation where outsourcing offers a cost saving; (ii) specialised

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<sup>9</sup>. Although Williamson's theory was originally formulated in terms of production costs, he also argued that asset specificity and demand uncertainty are joint conditions for a decision to make a product in-house. In other words, the transaction cost theory covers other costs such as those involved in searching for sources of supply and information, as well as the costs of monitoring and enforcing contractual performance. The 'cost' concept can be widened to include, for example, the loss of market share which arises from the extended innovation cycles which may be 'thought' to have arisen through externalisation.

sub-contracting, motivated by the lack of internal capacity and technical capability to produce in-house; (iii) capacity sub-contracting, motivated by the need to balance demand and supply given limited internal capacity. Many inter-firm relationships fall in the category of specialised and economic sub-contracting. Subcontracting has been criticised for being based on unequal power relations stemming from the hitherto adversarial model of inter-firm relationships. However, based on the Japanese model which supports long-term collaborative relationships, the western model of subcontracting has recently altered toward more reciprocal relationships (Tumbull et. al., 1992).

### *Licensing and Franchising*

A second variant of the strategies used in rationalisation is licensing, with franchising being a special case of licensing. The large firm extends the rights to use patents and other rights at a consideration (royalties). In this form of outsourcing, the externalising firm expands its markets by increasing capacity without making further capital investments, and without bearing the expansion risks. Hence, by decentralising production while retaining standardisation, the parent firm can achieve economies of scale using current investment levels, while providing 'turn-key' business opportunities for SMEs. Because the licensee uses proven, patented technology (blue prints), the operational risks are likely to be relatively lower than those of an independent business. However, local adjustments made to adapt to local conditions are likely to be expensive for the licensee. Because of this and other reasons, licensing has not been widespread.

### *Strategic Partnering*

Various forms of strategic alliances and collaborations are quickly gaining ground in developed countries as a form of productive organisation which accesses scarce inputs, and wider markets. Cooke (1988) makes an important distinction between two forms of alliance - the more complex strategic alliance, and the more common tactical alliance typical of horizontal integration through inter-firm co-operation, stating that the former are goal-seeking, formalised and long-term. Strategic alliances have also changed the form of subcontracting in industries where proprietary technology is critical for competitiveness, where more long-term collaborative relationships are forged, based on exchange rather than power relations. Joint Ventures (Kogut, 1988; Harrigan, 1984; Harrigan and Newman, 1990) are perhaps the most frequently used form of alliances, although one-off collaborations are also reported, particularly in high technology industries (Ernst, 1987).

## **2.4 CONCLUSION**

This chapter has examined the role of SMEs in development by first discussing the roles documented in the literature, then proposing a logic for SME development. The analysis in this

chapter reveals that by measuring the sector in isolation, its role and contribution to development has been under-valued. Based on the role which the sector has played in the Japanese and German economies, the chapter proposes that the contribution of the sector lies not in its isolated contribution to employment generation, regional development, technology development, or to national output, but its contribution as part of a composite industrial structure. In addition, whereas industrialised countries are pressured to provide employment and regenerate the economy, hence their emphases on this role of SMEs, in developing countries, where large firms have hitherto dominated industrial activity, the SME sector has the socio-political role of restructuring ownership of resources from large (usually foreign) to small indigenous firms.

This chapter further proposes that one strategy for addressing poor economic performance is to shift away from the paradigm of mass production towards a small-batch production paradigm, thus offering a logic for SME development. The post-Fordist paradigm, advocating flexible production organisation, not only provides a rationale for SME development by questioning the logic of mass production, but also provides a framework for production decentralisation (through externalisation) and re-organisation (through contracts and strategic partnerships). Thus, by downsizing and disaggregating large firms, and re-organising transactions in various flexible integrative models, SMEs can be developed, their contribution being realised within a composite industrial productivity framework rather than in isolation.

This discussion has covered a variety of firm sizes falling under the rubric of 'small and medium enterprises' (SMEs). For example, in many developing countries, for various reasons, the informal sector (sometimes referred to as the micro-enterprise sector) is generally still excluded from national statistics (de Soto, 1989). On the other hand, many of these countries promote 'formal' small and medium enterprises. This study is interested in the 'formal' small and medium enterprises as these are more likely to have the technological and skill base to meet the needs of large firms in Kenya. In Kenya, small enterprises have historically played a composite role of indigenising industry and commerce, while at the same time providing employment for its large population. The sector has recently also become the government's channel for economic regeneration in the face of the realisation that large firms have a limited capacity for providing wide-spread economic benefits to the Kenyan population (GOK, 1989).

In this chapter, reference was also made to the Japanese experience in using a large-firm small firm linkage strategy for its industrialisation. While this has continued to be a model for developed and developing countries, care must be taken in drawing parallels with developing countries. Japan's category of small enterprises typically covers firms employing less than 500 people, with the average of about 300 people (Sato, 1989). These firms are also likely to use sophisticated technology and skilled manpower. On the other hand, many developing countries define small

enterprises as those employing less than fifty people. These are also likely to be less capitalised, and less sophisticated than the Japanese case. However, while direct parallels are not appropriate, the logic of size distribution of industry is a plausible strategy in most environments.

The following chapter, three, discusses some of the literature 'explaining' the existence of inter-firm relationships. While the literature is vast, it offers highlights some key issues pertinent to the formation of relationships between organisations.



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## CHAPTER THREE

### INTER-FIRM RELATIONSHIPS: SOME KEY ISSUES

#### 3.1 INTRODUCTION

In chapter two it was argued that the role of SMEs is its complementarity with large firms, and that this complementarity can be achieved, *inter alia*, through inter-firm linkage strategies. The broad aim of this research is to explore how large firms can be encouraged to form such linkages with small firms. It entails establishing, therefore, whether or not large firms in Kenya use inter-firm linkages and what factors influence their sourcing decisions. The formation of linkages is argued to be predicated on a firm's decision to dis-aggregate or to outsource their requirements. Hence, factors influencing vertical integration, or those discouraging dis-aggregation are important. This chapter reviews the received theories about (i) motivations for inter-firm relationship formation; and (ii) motivations for vertical integration or de-integration. It also argues that in addition to their various idiosyncratic weaknesses, these frameworks have limited applicability in developing country contexts.

Three broad approaches to the explanation of inter-firm relationships are advanced in the literature. Although these approaches are presented separately, they are not counterposed arguments. For example, in so far as flexible specialisation involves JIT production and the need to be close to final consumers, then it has spatial implications. The separation of approaches is used, therefore, for clarity and focus.

The spatial approach draws on theories of agglomeration to argue that inter-firm relationships result from firms locating themselves where they can access resources and markets within a particular geographical setting. A second approach takes a macro-economic perspective to hypothesise various factors triggering vertical de-integration, 'forcing' firms to use inter-firm relationships to access resources and markets. Clearly, these two approaches attribute inter-firm relationships to external factors, which are difficult to replicate in an economy. They also discount the fact that industry behaviour is an aggregate of managerial decisions taken at firm level. This research, therefore, adopts this intrinsic managerial perspective to 'explain' inter-firm relationships.

The managerial "explanation", adopts a variety of approaches to the study of inter-firm relationships. Transaction cost theory is the most frequently used, arguing that inter-firm relationships are a strategy for achieving efficiency. A second body of literature argues from an

organisational theory standpoint, that inter-firm relationships are a strategy for achieving structural flexibility, through vertical de-integration, while retaining scope and scale. Yet a third body of literature posits that inter-firm relationships are a result of strategic behaviour by firms. Within this argument, various emphases exist based on the perceived objectives of the firm: competitive advantage and strategic positioning (Porter, 1985), as a strategy for entering new markets; to gain access to scarce resources (Benson, 1975); to gain access to technology (Forrest, 1992; Rothwell, 1989); in search of core competence (Prahalad and Hamel, 1990); for more effective supplier chain management (Porter, 1985); production planning; labour process management (Atkinson, 1985); and strategic collaboration (Thorelli, 1986).

The chapter discusses these approaches in five sections. This first section introduces the chapter, while the second section presents an overview of the various approaches to the "explanation" of inter-firm relationship formation. The third section discusses the managerial decision-making approaches in more detail, while the fourth section explores the peculiarities of developing countries and their potential impact on inter-firm linkage formation. The fifth section concludes the chapter.

### **3.2 APPROACHES TO THE STUDY OF INTER-FIRM RELATIONSHIPS: AN OVERVIEW**

Inter-firm linkages have been variously 'explained' in the literature: socio-economic pressures triggering vertical de-integration; spatial location and agglomeration; managerial decision-making.

*External Socio-economic pressures:-* A large body of literature argues that emerging trends in large firm-small firm linkages are a result of fragmentation activities of large firms responding to wider external pressures (Piore and Sabel, 1984; Sabel, 1982; Scott and Storper, 1986; Shutt and Whittington, 1986). Although their work essentially tries to explain the persistent presence of small firms in the economy, it has bearing on the implications of fragmentation of large firms and the potential for smaller units absorbing the resulting 'fall-out'. Relationships between large and small firms is conceptualised, therefore, as the result of a process of fragmentation by large firms, and their externalisation of activities to small firms as the result of rationalisation for efficiency; flexibility as a coping strategy; flexible technological specialism; or investment stabilisation. Shutt and Whittington (1986) and also Howells (1989) identify several factors which they hypothesise to influence the formation of dependent and independent small firms through the process of fragmentation. These include the effects of the recession and unemployment which has forced large firms to restructure by means of closures and bankruptcies; the rise in the number of 'niches' of demand because of developments in new technologies; the effects of the end of the post-war boom and the pressure to restructure relations between capital and labour (Gordon, Edwards and

Reich 1982); and to counter the effects of increased innovation and demand risks. The main weakness of this approach is that it examines the factors which cause fragmentation but does not shed light on the internal processes leading to fragmentation of large firms.

A related body of literature analyses emergent inter-firm relationships and networks (Larson, 1992; Brusco, 1986; Becattini, 1989; Lorenzoni and Ormati, 1988; Thorelli, 1986). Thorelli's work, for example, argues that firms form networks as an alternative between markets and hierarchies in an environment of interdependence, although he concedes that "power is the central concept in network analysis" (Thorelli, 1986:38). A section of this literature introduces another dimension by positing that small firms use inter-firm relationships in the form of networks to counter the negative effects of small size, for example competing in markets where economies of scale are important (Brusco, 1986; Becattini, 1989). According to this thesis, networks are used as a vehicle for entry into resource and/or consumer markets. This literature, therefore, views inter-firm relations as a strategy, by small firms, for entering into markets hitherto inaccessible to them. A second part of this literature views inter firm relationships as a network of inter-dependent firms which form linkages as a response to external pressures, for instance changes in demand patterns requiring flexible work organisation, which have implications on productive organisation and related issues of division of labour (Atkinson, 1985). A large body of controversial literature has emerged which explores the issue of flexibility under the banners of Flexible Specialisation, Post Fordism, among others, explaining inter-firm relationships as part of a restructuring of organisations and industries.

*Spatial location:-* On the other hand, Shutt and Whittington (1986) and other industrial geographers 'explain' inter-firm relationships, such as sub-contracting in relation to spatial agglomeration, with small firms locating close to large firms. Following this argument, therefore, it is hypothesised that large firms act as 'hubs' around which other firms agglomerate as either buyers or sellers, thus creating a network of inter-related firms. The main criticism of this thesis argues that given the level of innovations in information technologies (Gershuny and Miles, 1983), inter-regional transactions are possible. Neither does it provide evidence that large firms will seek out smaller firms as partners, or indeed that small firms will locate in the vicinity in order to exploit such relationships. Proximity of buyers and suppliers is, therefore, not necessarily a valid 'explanation' for inter-firm relationships of firms within a particular locality.

*Managerial decision-making:-* Clearly, the literature outlined in the preceding paragraphs views organisations merely as responsive elements in a wider economic or spatial system. It does not take into consideration the managerial process by which such responses are formulated and executed. In addition, it ignores the fact that organisations, to some extent, determine their environment and change it by their actions. Earlier theorists such as Child (1972) correctly argued

that through strategic choices, organisations alter their business environment which, over time, changes these environments. Miles and Snow (1978) refer to this process as 'enacting the environment' to mean the process by which organisations take action to 'align' themselves to the environment as a positioning strategy. Thompson (1967) extends this argument to suggest that in order to do this efficiently, firms segment their environments and take separate decisions to deal with each environment. Also important in this discussion is the concept of 'domain definition', which Miles and Snow (1978) and Miles, Snow and Pfeffer (1974) describe as "the selection of activities which facilitate adaptation". By this definition, a firm makes choices about its domain - the components and pattern of its inter-relatedness with elements in its environment (Eg. customers, suppliers, unions, and other 'pressure' constituencies). This apparently intrinsic organisational process requires an analysis of the internal 'explanations' for inter-firm relationships. Merely examining the external forces which are hypothesised to trigger them does not suggest how to stimulate such relationships on a wider level. In addition, because such external factors can be difficult to replicate, it is prudent to look inside firms for answers to the question of how to stimulate inter-firm relationships.

In the overview presented in this section, it is apparent that inter-firm relationships have been studied largely as an outcome rather than as a process. Consequently, in documenting conditions or the process by which they are formed, external factors attributed to their formation, or the nature of emergent relations have been documented. Williamson's (1975) work which studies inter-firm relations as an internal managerial process, is perhaps, the first to draw attention to the internal managerial processes of firms as the key to 'explaining' inter-firm relationships. The following section reviews the managerial approaches to inter-firm relationship formation.

### **3.3 THE MANAGERIAL EXPLANATIONS FOR INTER-FIRM LINKAGE FORMATION**

Managerial explanations to the formation of inter-firm relations argue specifically from a managerial decision-making perspective. As Harrigan and Newman (1990) correctly argue, to understand inter-firm relationships, the motivation and propensity of firms to relate must, first, be understood. By this is meant the firm's 'desire' and 'inclination' to relate with another firm, perhaps, to access resources, markets or technology. As already mentioned, recent global experiences suggest that answers can be found by examining the external pressures causing such developments, particularly those related to changes in demand patterns. As noted, these external pressures are, however, difficult to replicate in an economy. Since it is the decisions of individual firms which aggregate into what is considered industry behaviour, other more intrinsic managerial explanations are suggested, namely: (i) that firms are searching for competitiveness by focusing on 'core competency' (Prahalad and Hamel, 1990); (ii) the increasing importance of the strategic

implications of the efficiency of the supply chain to the competitiveness of the firm (Porter, 1985; 1990); (iii) the replacement of internal markets with external markets as one strategy to increase the value of the supply chain (Porter, 1980); (iv) the development of cooperative strategies by firms as a strategy for entering markets and accessing resources; and finally (v) the development by smaller firms, of co-operative strategies for entering markets hitherto 'inaccessible' to them because of scale related barriers (Brusco, 1982). Hence, this category of explanations recognises that the explanation for industry behaviour can be found by examining individual firm behaviour: decisions about production organisation, organisational structure, sourcing activity, and the use of inter-firm relations.

Harrigan and Newman (1990) have also argued that this decision is largely predicated on the benefits of the linkage to the firm; whether the resource or market offered by the 'partner' is critical to its activities; the costs of co-operation/linkage, including transaction costs, opportunity costs, strategic inflexibility resulting from co-operation, and damage to a firm's strategic advantage when such linkage occurs; whether alternative strategies exist, or whether other sources of inputs or markets can be found; and the need to cooperate in order to access desired markets or resources - the centrality, urgency and necessity of the resource or market to the other activities of the firm. Clearly, the central concern is the motivation of a firm to form relations with another firm, and how it perceives the possibilities of achieving its objectives using this strategy. This has led this study to focus on the factors motivating a firm to form linkages with other firms as part of its business strategy.

Casson (1987) makes a similar argument, but provides a useful categorisation which brings together the many of the issues raised in the literature. He groups the factors influencing the choice of contractual relationships against internal development into four broad categories:

- (a) The nature of the advantage sought from the relationship. This means the advantage that the firm is seeking in forming relationships. Consequently, if a firm does not perceive an advantage, it is less likely to pursue inter-firm linkages.
- (b) The nature of the firm, and its ability to 'support' the relationship.
- (c) The nature of industry, and norms, relative stability, levels of uncertainty, etc. This means the industry environment within which the firm operates. Consequently, if the firm seeking a relationship concludes that the nature of competition or industry activity are best addressed using inter-firm linkages, then such a strategy will be used.
- (d) The nature of the wider business environment. This refers to the country or international setting within which managers have to make their decisions. As Porter (1990) has argued,



the wider environment determines, to a large extent, whether a firm uses internal or external markets. The most prominent of these conditions is the extent to which the supplier infrastructure offers adequate choices for a firm to use markets.

### 3.4 EXPLANATIONS FOR INTER-FIRM RELATIONSHIPS: SOME APPLICATIONS

This review seeks to highlight the various approaches to the explanation of inter-firm relationships, and the various assumptions underlying their use in analysing motivations for such relationships. The literature can be discussed under the various approaches which are relevant in explaining the motivations and choice of inter-firm relationships, assumptions made about their nature, and requisite conditions for their existence: (a) transaction cost theory (driven by efficiency and cost minimisation); (b) organisation theory; and (c) strategic behaviour (driven by competitive positioning).

#### *Transaction Cost Theory Approach*

The seminal work by Williamson (1975) on the implications of transaction costs in the firm's decisions about internal or external markets is, perhaps, the first study to suggest that internal firm behaviour explains organisational structural patterns and trends. The Transaction-Cost logic in organisational studies builds its argument on the theory of the firm, which has as its starting point the unique capabilities of the firm. The underlying logic of this approach is efficiency and cost minimisation within a framework which assumes rationality. Consequently, it argues, management activities seek to formulate strategies which create and exploit the firm's uniqueness (Lenz, 1980; Kotler, 1984).

Although the transaction cost approach has been used to analyse a wide variety of organisational activity, for example, bureaucracy (Williamson, 1979); franchise contracting (Williamson, 1976); clan-like relations within firms (Ouchi, 1980) or organisational culture (Jones, 1983), its most widespread use has been in the interpretation of the vertical integration of production and of various forms of contractual relations (Williamson, 1971; 1975; 1985). Williamson (1975; 1985) explored the methods of determining transaction costs, and their effect on exchange. This theory argues that organisations seek to minimise their transaction costs, thus determining their organisational form under the assumption that the most efficient structure will displace the others - a common, cost minimising organisation, which involves maximisation of the value of the output of the firm relative to production costs (Robins, 1987). Basing his work on that by Coase (1937) which argues that firms and markets are alternative methods of co-ordinating resource allocation - transaction, Williamson (1975, 1985) proposes that firms choose modes of transaction according to the criterion of minimising the sum of production and transaction costs. Williamson's (1979) argument is, in turn, based on the proposition that the most efficient mode of governing transaction

depends on (1) uncertainty associated with executing the transaction, and (2) the uniqueness or specificity of the assets associated with the goods or services transacted. In these cases, Williamson (1985) argues, opportunistic behaviour is expected.

Contradictory arguments, such as those of Walker and Weber (1984), in their study of a company in the automobile industry in the USA, maintain that production costs are the strongest predictor of make-or-buy decisions and that both volume uncertainty and supplier market competition have small but significant effects. Production costs may differ between firms due to the scale of production, learning, or proprietary knowledge, while transaction costs refer to the expenses incurred for writing and enforcing contracts, negotiating terms and contingent claims, deviating from optimal kinds of investments in order to increase dependence on a party or to stabilise a relationship, and administering a transaction (Williamson, 1985). In essence, it refers to all forms of search, information, and negotiation costs, as well as the costs of monitoring and enforcing contractual performance. He argues that these costs may be reduced by the organisation of exchange through a variety of non-market apparatus, including bureaucratic administration - vertically integrated organisations. However, bureaucratic administration involves both the cost of maintaining an administrative apparatus and the potential loss due to the (theoretically) greater efficiency of the market in transmitting information. Hence, the bureaucratic organisation alternative is appealing where market organisation of economic exchange is cumbersome, and costly, and other forms of transaction governance are necessary.

Williamson (1975; 1985) further argues that the principle feature of high transaction costs between arms length parties is small numbers bargaining in situations of *bilateral governance*, which results when switching costs are high due to asset specificity - that is, the degree to which assets are specialised to support trade between only a few parties. It must be noted, however, that asset specificity is not a sufficient condition for high transaction costs - uncertainty and frequency of transactions are also necessary (Coase, 1937; Williamson, 1975). Depending on its objectives, a firm may still choose to produce in-house (hence vertically integrating) even though its transaction costs are higher than those of outside suppliers. Harrigan (1985) has suggested some of the conditions under which such decisions are made, namely: settings of competitive stability and low demand certainty; when the firm lacks the bargaining power needed to persuade outside suppliers to assume the risks which they hoped to avoid by outsourcing; or because vertical integration fits the parent corporate strategy needs.

Several criticisms can be levelled at the transaction-cost theory approach to organisation studies, particularly those relating to inter-firm relationships. First, the main limitation of Williamson's work in 'explaining inter-firm relations is that it assumes the primacy of cost-oriented organisational goals (efficiency) though it is widely acknowledged that firms have reasons other

than those of cost minimisation/profit maximisation for making choices about structure, size and production organisation (Porter, 1980, 1985; Harrigan, 1984, 1985). More specifically, various interorganisational relationships could be motivated, for example, by other considerations such as those referred to in preceding paragraphs, namely necessity, asymmetry or power-dependency, reciprocity or exchange, stability, legitimacy, domain consensus, and access to resources. It is also probable that a firm will pursue several goals simultaneously (Thompson, 1967), and will therefore be variously motivated. Hence, motivations can be interactive. For example, efficiency motivates are not necessarily primary, nor do they exclude other goals such as power and control over the business environment, or indeed over some constituencies within this environment.

Secondly, this theory is predicated, as are most economic models, on the assumption of the rationality of decision makers, who are also assumed to have access to information. Yet, often, decision makers are neither rational, nor do they have access to 'all relevant' information for decision-making - bounded rationality (Williamson, 1975). This approach also reduces all of a firm's activities into a cost reduction objective, which is not necessarily the case. For example, Porter (1980, 1985) reduces competitive advantage as well as differentiation strategies into cost reduction, and rivalry is reduced into brand loyalty benefits. While this is an appropriate starting point for conceptualising and operationalising strategy at firm level, it does not take into consideration the role of objectives other than cost minimisation and/or profit maximisation. Thorelli's (1986) argument that cooperation and collaboration are also motivations for inter-firm relationships contradicts this proposal. DiMaggio and Powell (1983) also argue, for example, that joint venture activity, a particular form of inter-firm relationships, can be analogous to fashion trend setting as a form of band-wagon behaviour. Rumelt (1974) also stated that in some cases structure also follows fashion. This can be explained by arguing that industry participants rely on collective industry wisdom, and therefore, what is interpreted in these studies as fashion or band wagon behaviour is simply the expected adoption of particular strategies by firms within the same business environment. Not surprisingly, however, this perspective does not receive more than a casual treatment in the literature.

Finally, the Transaction Cost Economists' perspective dichotomises a firm's choices between markets and hierarchies, ignoring the possibility of other, diverse business objectives as discussed above (Thorelli, 1986; Ring and Van de Ven, 1992). Hence, other governance forms, other than the pure dichotomy of markets vs hierarchies, exist: strategic alliances (eg James, 1985); partnerships (eg Perlmutter and Heenan, 1986); coalitions (eg Porter and Fuller, 1986); franchises (eg Friedlander and Gurney, 1981); research consortia (eg Ouchi and Kremen-Bolton, 1988); joint ventures (eg Kogut, 1988a; Harrigan, 1985) and various forms of network organisations (eg Jarillo, 1988; Powell, 1987; 1990); and various forms of quasi-integrated structures (Harrigan, 1985).

Hence, Ring and Van de Ven (1992) argue that while the transaction cost economics

"approach provides a sound theoretical foundation for the exploration of market versus hierarchical mechanisms for solving strategic dependencies, it suffers from not adequately exploring such other available governance structures, repeated transactions, the dynamic evolution of governance and transactions, and the key roles of trust and equity in inter-organisational relationship" (p483)

Thus, while transaction costs and strategic motivation explanations provide compelling economic reasons for inter-firm relationships, there are other explanations outside the economic rationality, particularly that considering short-term benefits.

### *Organisational Theory Approach*

The organisation theory approach to the explanation of inter-firm relations posits that inter-firm linkages are the outcome of structural restructuring of firms either as an organisational 'learning process' or, more prominently documented, as a strategic decision about organisational structure.

In the former approach, it is argued that economic agents seek and discover information through organisational learning as a social process rather than simply a price co-ordinated outcome. Pettigrew and Whipp (1991) aptly state

".....economic relations are in large measure the result of experience and learning over time. Economic explanation should therefore be a dynamic exercise. Economic activity is not co-ordinated simply through price mediated transactions. It is informed by a range of social institutions ....."(p19)

Consequently, inter-firm relations can be argued to be an outcome of past experiences of the firm within a certain social milieu. Concurring with this argument, Kogut's (1988a) example of joint ventures serves to highlight the implications of this argument. He posits that joint ventures are a means by which firms learn or seek to retain their capabilities by transferring their 'tacit knowledge' - referring to the organisationally embedded knowledge base (Polanyi, 1967) to partners. While this perspective is frequently identified with a transaction cost argument, its explanatory factors are organisational and cognitive rather than derivatives of opportunism under uncertainty and asset specificity. For example, as Kogut (1988a) argues, because knowledge can be transferred without a contract, the transfer of know-how is encumbered by the hazards which accompany the pricing of information without revealing its contents. Consequently, the market fails as sellers are unwilling to reveal their technology and buyers are unwilling to purchase in the absence of inspection. However, when the market is replaced by a joint venture, it is not because tacitness is a cost stemming from opportunism, but rather from the necessity of replicating



experiential knowledge which is not well understood (Kogut, op. cit). More generally, because tacitness is an aspect of the capital stock of knowledge within a firm, inter-firm relationships result when neither party owns each other's technology, procedures, or tacit knowledge - occasioning reciprocal dependency. Hence, in the case of joint ventures, Kogut (op. cit) concludes that a joint venture is encouraged under two conditions: one or both firms desire to acquire the other's organisational know-how; or one firm wishes to maintain an organisational capability while benefiting from another firm's current knowledge or cost advantage. Inter-firm relationships such as joint ventures and other quasi-integration relationships can, therefore, help a firm to access resources or markets.

The second perspective of organisational theory is more prominently documented - that inter-firm relationships are an alternative form of production organisation motivated by organisational structure considerations, based on 'make' or 'buy' decisions. Internal growth and development are used when 'make' decisions are made. This means that internal structural provisions must be made following this strategy, usually taking the form of vertical integration. On the other hand, inter-firm relationships are used in the case of 'buy' decisions. This could take the form of coalitions and strategic partnerships, or contractual relationships with independent organisations. *Table 3-1* presents a useful summary of the relationship between strategy, structure and markets. In this respect, inter-firm relations can be viewed as a managerial decision to integrate as opposed to using markets or quasi-market arrangements to procure resources (Harrigan, 1984). Arguably, two basic approaches to productive organisation can be identified: that which involves using internal structures (vertical integration); and that which involves using external structures (inter-firm relations) although other forms of transaction governance fall along the continuum. For example, Harrigan (1984) identifies a variety of governance forms which she labels 'quasi-integrated' structures. Other authors such as Kogut (1988a) pick up this theme and identify other relationships such as strategic partnerships and collaborative arrangements. A brief review of the implications of these options follows.

*Table 3-1      Strategy, Structure and Market Options*

Strategy	Structure	Markets & Governance Structures
Internal Growth	Integration	Internal markets & In-house production
Inter-firm Relationships	Dis-integration	External Markets & Outsourcing



### *Internal Growth and Development (Vertical Integration)*

Internal development implies that a decision has been made to produce a component or service in-house, and structural provisions must be made for it, and for the co-ordination of the resources deployed. This results in vertical integration. For many organisations, internal development has been the primary method of strategy development, particularly in industries where products are highly technical, markets are volatile (Harrigan, 1984; 1985), there is need to acquire internal skills related to the product (Johnson and Scholes, 1989), or where there are no known or suitable suppliers of the input (Harrigan, 1985). By making the 'make' decision, therefore, firms simultaneously make resource allocation decisions which put in place an internal mechanism to co-ordinate them.

The literature on vertical integration is vast, and to some extent context specific. However, a recurrent theme is the attempt to explore the conditions which influence vertical integration or de-integration. In summary, four key factors suggesting reasons for vertical integration, emerge from the literature: (i) market failure; (ii) relative imbalances in market power between adjacent stages of industry, hence defending market power; (iii) the need to create market power by integrating firms; (iv) developing young or declining markets when adjacent independent investors are pulling out.

*Market failure* or inefficiency of markets, perhaps the most critical of these factors, is a combination of several factors which cause the buyer or seller to perceive failures in input markets, introducing a high level of risk and unreliability. Market failure generally involves the following features, none of which singly or alone signify a vertical market failure, but act in tandem.

1. A small number of buyers and sellers which creates power imbalances in the supply or distributions chains. The main rationale for vertical integration, in this case, is usually the possibility of 'unfair' prices or market foreclosure. This is exacerbated by high uncertainties within the business environment.
2. The presence of high asset specificity, durability and intensity, factors which raise entry and exit barriers and switching costs. The effects of specificity are magnified when the assets are also capital intensive and durable and when they give rise to high fixed cost structures.
3. A high frequency of transactions between buyer and seller, accompanied by "bilateral oligopolies and high asset specificity" (Stuckey and White, 1993), making them

dependent on each other, and hence vulnerable - high frequency seems to justify in-house production.

4. Opportunism by suppliers or buyers in monopolistic or oligopolistic situations, exacerbated by high uncertainty and bounded rationality.
5. Uncertainties brought about by legal and other restrictions, including political and social climates. Hence firms will form relationships in response to government mandates restricting access to markets or resources, or those erecting entry barriers.
6. Bounded rationality which circumscribes the extent to which managerial decisions can be made for all possible outcomes in the future - assuming that all firms make rational decisions.

These factors threaten market efficiency, creating the need for internal development of productive activities (Stuckey and White, 1993). It is within this framework that this study postulated that inter-firm linkages are predicated on a firm's propensity to vertically dis-integrate. Hence, for a linkage strategy to be applicable, it must first be established whether there are incentives for firms not to integrate, or dis-integrate where they have already integrated. In other words, where there is an efficient market, firms are less likely to integrate.

Hence, imperfect competition, which explains vertical integration, is also applicable - tying downstream distributors or depriving competitors of raw materials or stabilising oligopolistic competition. Kogut (1988b) uses this to explain joint ventures while (Katz and Shapiro, 1985) argue that strong network externalities help to avoid costly duplication among firms, with possibilities for lower prices and improved quality in the final market. In another example, Friedman, Berg and Duncan (1979) found that firms which use joint ventures tend to lower R&D expenditures, supporting this contention. Consequently, for firms to form inter-firm linkages, factors which cause market failure have to be removed, along with other uncertainties and legal restriction.

*Defending market power* means that if one stage of industry chain exerts more power over another, and thereby achieves abnormal returns, it may be attractive for participants in the dominated industry to enter the dominating industry. Hence, firms further down is the industry chain 'buy' into adjacent sectors. This is evident in the motor vehicle industry where manufacturers buy into components and parts industries as an assurance against loss of power. To limit vertical integration, therefore, those factors increasing the relative power of adjacent stages of industries have to be removed. The abnormal profits made by the marketing sub-sectors of vehicle industries, for example, have the potential of promoting vertical integration.

*Creating and exploiting market power* is an influencing factor for vertical integration, particularly when entry barriers are high. In effect, vertical integration also achieves the goal of raising entry barriers for the integrating firm such as accumulating proprietary knowledge, retaining highly skilled labour, and accessing finance and technology. Market power can also be achieved through price discrimination.

Vertical integration is also used to *develop young or declining markets* when adjacent independent investors are withdrawing from a market. This emanated from, and is related to the need to establish continuity in accessing markets even when other investors have pulled out. Clearly, firms which take this option are acting out of lack of choice - an element of market failure. Arguably, this is also affected by investment costs. If the firm perceives high investment costs relative to the advantage anticipated, it may abandon that market altogether. Having said that, in the case of young markets, prospects for future returns can be considered a 'worthwhile' rationale for investment. Consequently a firm is likely to integrate vertically in anticipation of market share.

#### ***Inter-firm relationships (IORs) (External Markets and Quasi-integrated structures)***

The alternative strategy to internal development is the exploitation of external markets by using a variety of strategic alliances, partnerships, coalitions, and intermediate contractual relationships. These are used to cope with internal capacity deficiencies. In terms of resource allocation and co-ordination, the firm 'outsources' inputs and/or distribution channels. If competitive advantage is the primary goal of the firm, transaction cost theory would argue that linkages can lower total cost through co-ordination or joint optimisation, relative to the cost of in-house production, including the cost of assets relative to the frequency of transactions. While this is an important starting point to conceptualise such linkages, it is important to note that this cost related analysis does not always hold, and that other motivations for linkages are important (discussed in section 4.3.2 of this chapter).

Arguing from a transaction cost perspective, therefore, while there are benefits accruing from both alternatives, it is critical that the firm selects that strategy which has the highest cost saving capacity (Porter, 1985). Integration can save costs by eliminating the procurement, transportation, search and contract negotiation costs involved in market transactions (Williamson, 1985). On the other hand, the market has advantages of flexibility, off-loading fixed costs and utilising capacity more efficiently, and lowering exit barriers (Porter, 1980). In effect, firms are likely to shift emphasis about market use depending on the costs and benefits of each option. Generally, however, the costs of dis-aggregation could prevent vertical de-integration, particularly if investments in that activity are high (high exit barriers). On the other hand, arguing from a strategic perspective, firms base their decisions on their strategic positioning regarding access to

and control of resources and markets. Using external suppliers therefore becomes an option when such resources are held by others, and it is not possible to acquire them internally.

The role of management (the dominant domain) cannot be underestimated. In their Adaptive Model of Organisational Behaviour, Miles and Snow (1978) argue that management's perception of the business environment, and their selection of strategies, shape the organisation's structure and process. Williamson's (1975) analysis argues that the bounded rationality of managers limits the extent to which they can make informed decisions about alternative ways of organising production. In this study the attitudes and behaviour of management are considered to precede organisational behaviour. In addition, while cost considerations appear to be the logical motivation of firms aiming at competitiveness, personal and power positions of managers and other players in the organisational are likely to be stronger motivators for organisational behaviour. It has also been argued that the extent to which managers can scan the environment and process information determines the extent to which the organisational can adapt to its environment - the bounded rationality of managers (Miles and Snow, 1978; Williamson, 1985).

Finally, inter-firm relationships are motivated by strategic behaviour to deter or block entry, or erode competitors' positions. This questions the dichotomy between markets and hierarchies, and introduces the use of networks and other collaborative arrangements. For example, Vickers (1985) describes joint ventures in research as a way to deter entry through pre-emptive patenting. He demonstrates that for small innovations, a joint venture is an effective mechanism to guarantee the entry-detering investment. For large innovations, it is in the interest of each firm to pursue its own research, since the expected payoff justifies the cost. In another example, Vernon (1983) sees joint ventures as a form of defensive instrument by which firms hedge against strategic uncertainty, especially in industries of moderate concentration where collusion is difficult to achieve despite the benefits of co-ordinating the inter-dependence among firms. While this argument suggests that minimisation of transaction costs is an objective of the firm, it emphasises its competitive positioning considerations more, whether this is achieved through collusion or through depriving competitors of potentially valuable allies and resources.

### *Strategic Behaviour Approach*

A third approach to the explanation of inter-firm relationships stems from theories of how strategic behaviour influences the competitive positioning of the firm (eg. Harrigan and Newman, 1990; Porter, 1985). The main difference between the motivations attributed to transaction theory and those attributed to strategic behaviour relate to the objectives of the firm when making 'make' or 'buy' decisions. This means that decisions are taken not just to save cost, but for positioning relative to competitors. Transaction cost theory posits that firms transact by the mode which



minimises the sum of the production and transaction costs. Strategic behaviour explanations posit that firms transact by the mode which maximises profits through improving a firm's competitive position *vis a vis* that of rivals. Kogut (1988a) makes this distinction even more vivid for the purposes of this discussion:

"The primary difference is that transaction costs address the costs specific to a particular economic exchange, independent of the product market strategy. Strategic behaviour addresses how competitive positioning influences the asset value of the firm" (p322).

This study contextualised inter-firm relations as a managerial decision making process. It is expedient, therefore, to highlight the implications of competitive dynamics within a business environment, and what these imply for large-small firm linkages. Inter-firm relations occur within the framework of a firm's desire to achieve competitive advantage. In recent years, the competitive environment has become more challenging for firms, with resource management becoming the key tool for competitive advantage (Porter, 1992). Hence all organisational strategy and activity are aimed at this acquisition and superior positioning, involving managers in decisions of how best to allocate resources and organise the firm's activities to achieve this position. Because these questions are essentially managerial concerns about competitiveness, the competitive dynamics of the firm, and the role of inter-firm relationships are briefly considered. Proceeding from the argument that inter-firm linkages are a function of the strategic choices of a firm about its sources of inputs and disposal of outputs, it is pertinent to explore the concept and role of strategy and strategy formulation in organisational behaviour.

Three underlying assumptions about organisations guide this discussion. First, as a pre-requisite to competitiveness (cost leadership or product differentiation - Porter, 1985), firms are primarily concerned with resource acquisition and control (Benson, 1975; Provan, et. al., 1980). Hence, their activities, structures and strategies are geared towards this goal. Secondly, this calls for a definition of their domain in the environment through strategic choices, thus, '*creating*' their particular environment (Chandler, 1962; Miles and Snow, 1978; Miles, Snow and Pfeffer, 1974; Thompson, 1967; Weick, 1969). Consequently, as Miller (1988) suggests, to ensure competitiveness, the firm's structure, strategy and environment must be aligned (*strategic adaptation*). Finally, organisations aim to increase the value of their offering by increasing the value of their *value system* (all those activities which go into giving a firm its competitive advantage). Hence, the firm aims its organisational development strategies at this additionality (Porter, 1985).

Andrews (1987) like many other authors, appropriately argues that because corporate strategy "defines products and markets - and determines the company's course into the most indefinite future" (Andrews 1987: xi), the way firms make decisions is a function of how well they define



their products and markets, and how well they can envisage their distant future. Porter (1980), underlines this contention by stating that "the essence of formulating competitive strategy is relating a company to its environment." Consequently, how organisations view this task determines the perceived choices available, and the process by which the firm pursues competitive advantage.

Arguably, firms act upon the environment just as much as the environment affects the firm's decisions. As argued by Chaffee (1985:89) and others such as Biggadike (1981) and Lenz (1980), a basic premise of thinking about strategy concerns the inseparability of organisation and environment: "The organisation uses strategy to deal with environments". In analysing inter-firm relationships, this chapter suggests that the dynamics of competitiveness, and the relationship between strategy and structure provide a working framework. It proposes that firms act in self interest (survival) in the long term, and select options (as perceived by management) which perpetuate them in their business environment, the key issues being resourcing and disposal of outputs. Consequently, they make strategic and tactical organisational decisions in order to achieve these goals. To understand firm behaviour, therefore, it is critical to understand the drives behind the decisions and actions of organisations. While the former focuses attention on cost reduction, the latter focuses the firm's energies on product uniqueness. However, as argued by Pettigrew and Whipp (1991), even the focus on product differentiation is ultimately aimed at cost reduction via demand stimulation brought about by brand loyalty. Evidently, the significance of any strength or weakness a firm possesses is ultimately a function of its impact on relative cost or differentiation. Cost advantage and differentiation in turn stem from industry structure. They result from a firm's ability to cope with the five forces better than its rivals (Porter, 1985).

In turn, this advantage is evaluated in terms of its value to the buyers. As Porter (1985:3) has argued "competitive advantage grows fundamentally out of [the] value a firm is able to create for its buyers that exceeds the firm's cost of creating it" this value is translated into more superior returns than those of competitors. Hence, it is argued, decisions and choices about resources, markets, labour, etc. are geared towards this goal. Managerial approaches, which have taken supplier chain value maximisation, or production efficiency approaches to inter-firm relationships, have this basic assumption at the heart of their theorisation.

The *supplier value chain* is perhaps the most critical among Porter's five forces (viz. buyers, suppliers, substitutes, potential entrants, and industry competitors) which determine industry profitability since supplier bargaining power determines the costs and availability of raw materials and other inputs. Evidently, power over the supplier chain is critical for the organisation's competitiveness. The firm is therefore, keen to reduce the supplier bargaining power which is high when: (a) there is a concentration rather than a fragmentation of suppliers; (b) the switching costs

from one supplier to another are high; (c) the supplier's brand is powerful, which is linked to switching costs if these are dependent on the brand; (d) there is the possibility of the supplier integrating forwards if it does not obtain the prices, and hence the margins, it seeks; (e) the supplier's customers are of little importance to the supplier, in which case long term relationships are not important.

Emerson (1962) and Blau (1964) use social exchange theories to emphasise the firm's resource acquisition objective, contending that interorganisational dependencies are created by the need of all organisations to acquire scarce resources. This contention predicts that organisations are powerful relative to others, to the extent that they (1) control resources needed by others (2) can reduce their dependencies on others for resources. Success in the acquisition and control of resources has also been used as a measure of organisational effectiveness (Porter, 1980). Thus, in a very real sense, organisations are driven and evaluated by their relative success in the acquisition of such resources in their environment.

Other authors such as Benson (1975) propose that such power can be achieved, *inter alia*, through increased cooperation among organisations, which enhances the capacity of these organisations to dominate their environment. Hence, Benson's argument suggests that power in interorganisational networks is based not only on internal network exchanges, but also on external linkages to the larger environment. Provan *et al* (1980) extend this argument to suggest that an actor can lessen the power dependencies within a dyadic relationship by using power derived from relationships within larger organisational or social networks - for example, clusters of organisations such as those described in the Emilia Romagna model of networking among small firms in Italy are reported to provide a network for small firms, while giving them the necessary scale to relate with the wider environment (Brusco, 1986). Based on this argument, therefore, organisations are not concerned with their cost efficiency *per se*, but with their access to and control of resources and markets. But are these received models applicable in developing countries where the business environment is significantly different?

In summary, the foregoing argument implies that firms can make decisions to position themselves within a market, and in the process make decisions about acquiring and retaining resources, or blocking the access of rivals to such resources.

### **3.5 ISSUES AFFECTING INTER-FIRM RELATIONSHIP FORMATION IN DEVELOPING COUNTRIES**

The issues discussed in the preceding pages are based on research carried out in industrialised countries. The chapter has drawn on a vast organisation behaviour literature which offers a general, although incomplete, framework within which to investigate firm behaviour. Yet, managing in

developing countries can be different, with idiosyncratic features and characteristics which have significant managerial implications. Managerial decision-making is different and takes place in a severely uncertain business environment which can be heavily influenced by the state, and is fraught with market failure. The political economy in many of these countries that is significantly influenced by large MNCs, which effectively form market oligopolies. Finally, the supplier base can often be weak and fraught with difficulties.

(i) *Differences in managerial decision-making:* Managerial decision-making in developing countries is somewhat different from that in Western countries (Austin, 1990). This affects the options available to managers, in addition to tempering organisational behaviour in general. Managerial decisions are less likely to be rational as competitiveness is likely to depend, not just on cost or differentiation of products, but on the extent to which a firm denies its competitors access to resources and markets. Consequently, power becomes an important guiding philosophy for managerial decision-making. It is expected, for example, that because of the need to access resources or deny them to rivals, efficiency and cost minimisation could become secondary.

In addition, information is difficult to access due to its importance as a tool for competition. Managers find it difficult to access information owned by others, thus exacerbating the situation. Cooperation and partnerships are, therefore, less likely in developing country contexts where managers are constrained by lack of information, or because of limited trust, do not share it. Vertical integration is, in this case, a plausible strategy for retaining technology or proprietary knowledge within a firm.

(ii) *Uncertain business environments:* In his opening remarks to his book, Austin (1990) supports this contention, stating that "the fundamental difference [from the developed world] is the distinctive nature of the business environment". Also writing about the peculiarities of managing in developing countries, Kiggundu (1990) and others caution that there is need to view organisational behaviour in such countries differently, taking into consideration the complexity of the interplay between organisations and the state (Kiggundu, 1990; Tandon, 1982). Jaeger and Kanungo (1990), also agree with this view, implicitly emphasising organisational sensitivity to a given environment:

"in fact, the survival and growth of an organisation depends on its developing an appropriate culture that can adequately respond to external environmental forces. .... In developing appropriate coping strategies, organisations must be sensitive to environmental constraints and opportunities. Such sensitivity implies identifying and responding to three major aspects of the environment: (a) economic and technological, (b) political and legal, and (c) socio-cultural" (p.3)

These peculiarities include government controls, production difficulties, financial restrictions, skilled labour deficiencies, and market disruptions, among others. In addition, a volatile macro-economic environment poses special problems, with firms having to contend with high inflation rates. Coupled with a tumultuous political environment, these factors can have debilitating effects on firms. Hence, in view of these differences in the business environments of developing countries, which add up to produce a relatively uncertain environment in addition to a high concentration of industry, organisational behaviour does not necessarily follow the Western model which generally assumes that firms operate in a relatively free market and that market failure is the exception rather than the norm.

(iii) *The Role of State Influence:* This study recognises that one of the salient features of developing countries is the role of the state, which Austin (1990) views as the 'mega-force' operating at the macro level. The actions of the state substitute for and change the dynamics of market forces, by occasionally intervening directly (through tariffs, licensing, etc.) to influence the adaptation choices and processes of firms within industries, thus changing the competitive environment drastically. In this discussion, the state influences organisational choices by limiting the alternatives available in the market. Import licensing, for example, plays an important role in limiting managerial choices about inputs, while employment restriction limit access to skilled manpower. Other restrictions governing ownership of resources such as capital and land also constrain managerial choices. Doner (1993) gives an apt and succinct account of the role of the state in the development of some South East Asian countries, highlighting the role of government legislation in the industrial development of these countries. Contrary to Western models of industrialisation which advocate for the reduction of state intervention, some countries such as Japan and Italy have thrived because of variants of it (Porter, 1990).

In many developing countries the state has also been a competitor in both strategic and non-strategic industries, often introducing a different kind of industrial concentration by operating monopolies or supporting them as a strategy for attracting foreign investments. In most developing countries, state owned enterprises account for 7%-15% of GDP, and 15%-30% of gross fixed capital formation (Rumamurti, 1987). Through state owned enterprises, they control the activities of these industries, provide employment, and use them as principal foreign exchange earners. This economic importance has, necessarily, motivated most governments to give significant support to these enterprises, mainly in the form of protection, and preferential access to productive resources.

Austin (1990) also documents the role of the state in dictating domestic content in production activities, in effect controlling the sourcing possibilities in many industries. Doner (1993) also gives the examples of Malaysia, Thailand and Korea in positing that the motives of economic nationalism have led these governments to legislate the levels and nature of local content to be



used in some industries. The result, he argues, is a larger indigenous supplier base, with more 'local' technologies used. Kenya has followed a similar policy in the motor vehicle industry (GOK, 1989) although with limited success. At the micro- level, it is concerned with the strategic decision of where and how to obtain resources, and the necessary governance structures for these activities. At the macro level, this strategy involves the political economy and the management and distribution of resources and markets, particularly the process of bargaining, negotiation or edict which balance the power structure within the system.

Having said that, the state is not altogether a negative force in development. Current market orientation approaches to economic development advocate less 'interference' by the state, yet, recent experiences of the South East Asian countries offer a compelling, although qualified, rationale for state guidance in economic development. Authors such as Wade (1988) argue that in fact, the state can play a positive role in the industrialisation process by prescribing conducive business environments and 'guiding' resource use for predetermined periods in the country's development process.

*(iv) The role of MNCs in the Political Economy:* Another important consideration is the influence of foreign direct investment (FDI) in developing countries, particularly through the operations of Multinational Corporations (MNCs). As buyers and suppliers, they constitute a large proportion of the industries in which they operate, in many cases having monopoly status. Even in industries where competition exists, the collective power of competitors is generally lower, particularly when the competitors are local firms without access to the global marketing strategies available to MNCs. In many cases, they are also an important force in the political economy of these countries. An important consideration is their ability to source their requirements from a network of local and foreign associated firms. By virtue of their international nature, intra-firm transfers are to be expected. In addition, because they generally have access to foreign capital, technology and skilled manpower, MNCs often operate at a higher level of profitability than local firms. They can create competition through global strategies, thus achieving levels of profitability that are not possible for local firms operating in, often, depressed local economies only. These factors, among others, often create animosity within the local community, based on the argument that such firms have an 'unfair' share of the economy. Writing about the role and impact of MNCs in Kenya, for example, Kaplinsky (1978) maintains that they are important to the extent that they comprise of, largely, foreign capital; and control a large proportion of the resources and internal markets in Kenya. Consequently, national economic power is perceived to be vested in the hands of foreigners, engendering economic nationalistic sentiments among the locals. MNCs also command a large proportion of capital investment in many developing countries. For example, in 1992 in Kenya, about 70% of capital investment in manufacturing was accountable to foreign owned firms, a large proportion of whom are MNCs. In effect, therefore, MNCs control the industrial activity of many



developing countries. This scenario has engendered an adversarial relationship between MNCs, which are often large businesses, and local firms, which are often smaller businesses.

(v) *Market failure*: A related factor to (iv) above is the high concentration of industry in many developing countries. There is market failure in many industries, precipitated by a policy structure which still rewards (or omits to sanction) large size and concentration. Consequently, the level of competition is low with many industries having small numbers of buyers or suppliers. In addition to information scarcity (Austin, 1990) markets often fail because of such low levels of competition, government 'interference' in the private sector through controls and restrictions, and the lack of resources for potential local investors. Consequently, high levels of concentration in many industries have occurred. Concentration also has the effect of limiting 'incentives' for firms to be competitive as the high levels of protection discourage managers from seeking efficiency improvements. If developing countries industrialisation is to benefit from the ongoing global process of large firm de-integration, concentration has to be reduced. But first, the perceived risks of external trading must be removed through the increase of buyers and sellers as a strategy for reducing market failure.

Austin (op. cit) cites various studies indicating the nature and extent of problems encountered by manufacturers who wish to procure inputs domestically in developing countries. Studies of the South East Asian countries' electronic industry, for example, note that according to manufacturers in these countries, the largest problems of electronic component suppliers are insufficient quality (33%); high cost (17%); different product control standards (15%); and delivery delays (10%). A study in Singapore in 1978 also reported a 75% rejection rate of local producers in contrast to a 0% rate of Japanese suppliers operating in the same country. In addition, the Singapore supplier's prices were 40% higher than those in South Korea, Taiwan and Hong Kong (Austin, 1990). This means that given prevailing conditions, buyers have a case against local sourcing. Austin (op. cit) also argues, for example, that manufacturers generally use imported inputs as a way of bypassing the deficiencies of local suppliers. At the macro-level, one approach currently being used in some developing countries is de-regulation to allow entry into existing national monopolies and oligopolies. It is also expected that internationalisation of markets will increase the number of buyers and sellers in developing country environments.

(vi) *The Weakness of the local SME sector as suppliers*: Vertical integration is often attributed to market failure caused by a small number of suppliers, or the inability of existing suppliers to meet the needs of buyers. The small and informal sector businesses, expected to serve as the major suppliers within many industries in developing countries are perceived to be largely inefficient. This can be attributed to the limited access to productive resources, and the use of highly labour intensive production modes which tend to be incongruent with the quality and technological

requirements of 'modern' large businesses (Austin, 1990). The quality of the products of this sector are often said to be low owing to the low levels of capitalisation and access to productive resources and skilled labour.

Finally, the a discussion about managerial decision-making behaviour in developing countries would not be complete without a discussion about the scarcity of information. The very paucity of research information about organisational behaviour in developing countries limits the extent to which such relations can be hypothesised, modelled and used. First, little research has been carried out on the behaviour of organisations in developing countries generally. Consequently, little information exists to guide managerial decision-making in the peculiar environment outlined in the preceding paragraphs. In addition, no studies are available to explain inter-firm relationships in a developing country context. It is even less clear why large firms in developing countries form linkages, if any, with small firms.

### 3.6 CONCLUSION

This chapter has argued that in order to understand inter-firm linkages between large and small firms, it is critical to understand why or not firm enter into these relationships. To this end, this chapter has examined the generic and specific conditions determining inter-organisational relationships. Several approaches to understanding inter-firm relationship formation have been discussed, including the transaction cost, organisational learning, and strategic behavioural approaches. Based on the proposition that inter-firm relationships are essentially managerial decision activities about resource allocation aimed at facilitating competitive advantage, the strategic behavioural approach was favoured. As a result, the competitive dynamics of the firm were explored, arguing that the resourcing decisions of firms are geared towards securing a superior competitive advantage. *Table 3-2* brings together the issues raised in this chapter.

**Table 3-2      *Managerial Rationales for IOR Formation***

<b>Rationale for IOR Formation</b>	<b>Explanation</b>
1. Competitive advantage	The overriding rationale for managerial action. It assumes that all managerial decisions are aimed at competitive advantage either through production or supplier chain management (Porter, 1980; 1985)
2. Economies of scale and rationalisation of production (core competence)	Implies the search for lower average costs from larger volume and comparative advantage of 'partner' where scale economies are important.
3. Flexibility	The search for production, labour and resource flexibility. (eg Atkinson, 1985)
4. Blocking competition or entry	The defensive action by firms to pre-empt competition, or to erect entry barriers for competitors (Vickers, 1985; Vernon, 1983).
5. Meeting government mandated investment or trade barriers	Compliance with government regulations regarding, among other things, local content, access to markets, or access to certain resources (Whetten, 1981; Leblebichi an Salancik, 1982).
6. Access and defence of resources and markets	In competitive business environments, inter-firm relationships are used instead of internal development of capacity. Secondly, a 'partner' may have access to markets and resources not available to the other (Forrest, 1990; Pfeffer and Salancik, 1978).
7. Risk reduction (reduction of fixed costs, lowers capital investment, etc.).	Includes reduction of fixed costs to other sources. In other cases, this includes portfolio diversification without increasing investment costs.

Obviously, each of these factors has a 'flip' side. Although they are presented here as important for inter-firm relationship formation, they may also apply for vertical integration depending on management's perception of the certainty or uncertainty of the business environment. Arguably, for example, when managers are faced with an uncertain business environment which affects their

access to resources or markets, they are likely to integrate vertically in order to assure their supply. Risk reduction could mean reducing the dependence on 'external' sources for resources and markets. Hence, these factors must be assessed within the frameworks of the business environment described by Harrigan (1985) and Casson (1987) in preceding paragraphs.

Clearly, inter-firm relationships are perceived as a vehicle for resource acquisition. The structural implications of inter-firm relationships are also important. It must also be noted that it is possible for the firm to make the decision to outsource, but find the structural implications of sourcing too complicated, or that the industry cannot provide the required infrastructure to support external sourcing (Harrigan, 1984). Hence, in seeking to develop inter-firm relationships between large and small firms, it is pertinent to understand the relevant structural adjustment used to co-ordinate production organisation through external sources structures.

Although the approaches discussed here provide a useful starting point in "explaining" inter-firm relationship formation, two shortcomings must be noted. These theories have been developed by studying relationships between large, often public sector organisations in developed countries. Hence, little is known about the nature of inter-firm relationship formation between large and small private firms in such countries. The study sought to explore, therefore, those factors relevant in a developing country context. In addition, no specific studies have been undertaken to "explain" inter-firm relationship formation between firms in developing country contexts. It is argued that inter-firm relationship formation in developing countries will take different patterns, for various reasons such as state involvement. With this in mind, it is hoped that this study begins to address these gaps. However, it must be emphasised that this chapter does not seek to provide a conceptual model, but only highlights the salient issues in analysing the reasons why firms form inter-firm relationships.

The next chapter, four, examines some pertinent issues raised in this chapter in two examples of inter-firm relationship contexts - the Japanese and European vehicle industries. These examples were selected because of their prominence in the inter-firm relationship literature, and also because of the particular interest of this research in the motor vehicle industry of a developing country.

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## **CHAPTER FOUR**

### **INTER-FIRM RELATIONSHIPS IN THE MOTOR INDUSTRY**

#### **4.1 INTRODUCTION**

Chapter three examined some issues raised in the literature about inter-firm relationship formation. In no other sector of industry are inter-firm relationships, particularly subcontracting and joint ventures, more documented than in the motor vehicle industry. Due to this and the study's specific interest in the motor vehicle industry, this chapter reviews the nature and status of these relations and the lessons which can be drawn from it. On the whole, the literature suggests that there are three major reasons for the emergence of inter-firm relationships, particularly in the Japanese approach to auto-manufacture: JIT manufacturing techniques; the adoption of TQC procedures; and the adoption of simultaneous engineering. The first two have immediate relevance to Kenya, but because the country is at an early stage of manufacture, the third reason may not be immediately relevant.

The chapter begins by first reviewing the production philosophies and techniques which have developed within the global motor vehicle industry in this century. Since Henry Ford and the mass production epoch, the industry seems to have shifted in the past decade towards a less integrated production paradigm which has long been used by the Japanese. The chapter highlights this continuing restructuring of production organisation in the global motor vehicle industry and suggests that inter-firm relations in this industry can be attributed, largely, to this restructuring as firms seek global competitiveness. The chapter also reviews the nature and implications of inter-firm relationships in the Japanese and Western (American and European) models. The American and European models are largely based on a somewhat similar pattern of production organisation, and can therefore be regarded as adopting similar strategies in pursuit of competitiveness. On the other hand, the Japanese model is generally regarded as significantly different in basis and approach and is treated separately. Thus, although in both cases the overriding motivation for production restructuring in the motor vehicle industry is documented as the search for

competitiveness, the Japanese have adopted a different strategy from the Western manufacturers.<sup>10</sup> In essence, the Japanese have adopted an obligational approach to buyer-supplier relations, resulting in 'partnership' sourcing, while the western model adopts a generally arms-length approach. Although it is clear that not all auto manufacturers adopt partnership sourcing approaches, it has been documented by Turnbull (1991) and others that this discrepancy accounts for Japan's superior productivity in the automobile industry.

In order to incorporate other dimensions relevant in developing countries, this chapter also reviews some East Asian motor vehicle industry literature which suggests that state intervention through mandatory sourcing practices account for most of the inter-firm relationships in the industry. In addition, the need to control scarce resources and markets makes efficiency considerations somewhat secondary to having control of resources and markets (market power). Hence strategic positioning becomes dependent on such control, or denying competitors the very resources which make them competitive.

## 4.2 DEVELOPMENTS IN THE MOTOR VEHICLE INDUSTRY

### 4.2.1 OVERVIEW

In no other industry or subsector have inter-firm linkages, particularly subcontracting, been more extensively used and documented than in the motor vehicle industry. Particularly well documented are the Japanese, American, and more recently, European vehicle industries which highlight its importance in the economic development of these countries. This is not coincidental. The importance and impact of the motor vehicle industry has been both ubiquitous and pervasive.<sup>11</sup> It has also experienced some important changes in production organisation, in effect generally changing the way goods are produced and sold. This section first highlights the importance of this industry and then discusses these changes.

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<sup>10</sup>. The most often cited example is that of the US and Japanese automobile industries which used significantly differing strategies to cope with changing demand patterns which called for flexibility. Faced with growing competition from the Japanese, three US auto firms invested heavily (\$US 70 billion) in automation believing this to be the answer to the volatile demand patterns. This did not arrest the erosion of their market share. The difference in performance was explained by the different organisational frameworks within which similar automation was used in Japanese plants (Jaikumar, 1986).

<sup>11</sup>. For a more thorough examination of its pervasive nature, and an analysis of its impact on production approaches, see Womack et. al. (1990). A more general overview is adequately covered in Kenney and Florida (1993). Odaka (1984) also presents a good analysis of the South East Asian car industry.

#### 4.2.2 THE MOTOR VEHICLE INDUSTRY

More than forty years ago, Drucker (1946) dubbed it "the industry of industries". Since then, the motor vehicle industry continues to be the world's leading manufacturing activity, producing more than 50 million vehicles every year (Womack et. al. 1990),<sup>12</sup> with extensive backward and forward linkages with other industries. It has also long been considered a global paradigm industry where production and management techniques have been born and tested, and changes in industrialisation strategies initiated. Twice this century, the motor vehicle industry has revolutionised production paradigms, moving from craft production to mass production, and more recently to 'lean' or 'flexible' production, in event changing social, political, economic, and institutional structures. A simple but succinct summary of the importance of the motor vehicle industry is contained in the title of the analytical book resulting from five years of study of the international motor vehicle industry by Womack and his colleagues at MIT, Boston - "the machine that changed the world".

The industry has also been critical in propelling the industrialisation strategies of many countries. For instance, Japanese and American industrialisation strategies are based on it (Womack et. al., 1990). Japan has also long used it to model production techniques, and labour processes. As a result, based on Japan's economic performance as an indicator of the soundness of its economic development strategies, many countries in Europe and Asia have followed this exemplar. For example, countries of the Pacific Rim view the development of the motor vehicle industry as a logical strategy for faster growth in the manufacturing sector owing to its extensive linkages with other subsectors, particularly related parts, components and electronics subsectors (Doner, 1993).

Although many other developing countries also follow this exemplar, their motor industries are perhaps less prominent in their industrialisation processes, partly because of the relatively small size of the activities of their vehicle industries, and partly because these industries are predominately assembly rather than manufacturing based. Kenya, for example, although recognising the importance of this subsector as a 'hub' of industrial development (GOK, 1983), has not been able to achieve scale economies (Coughlin, 1988) because of the small domestic market

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<sup>12</sup> Womack and his colleagues at MIT, Massachusetts report the results of a global five year programme on the future of the automobile industry under the International Motor Vehicle Industry Programme (IMVP) at MIT. The main objective of the programme was to learn from Japanese techniques and approaches on how to improve efficiency and productivity in the global motor industry, with a view to drawing lessons for application in other industries. The term 'lean production' was coined by John Krafcik, one of the team leaders, as a descriptor of what was seen as the anti-thesis of mass production, arguing that it is mass production which was to blame for the gross inefficiencies in many industries of many countries, and that lean production is the answer to global economic stagnation. For a more detailed discussion of the project background and results, see Womack et. al. (1990).

with an annual estimated demand of 20,000 for new vehicles. Arguably, these low demand levels, and the predominately assembly activities make inter-industry linkages less extensive than those evident in Japan, South East Asia, Europe and America. The proliferation of makes and models has exacerbated the situation further by fragmenting the small markets even further. Consequently, scale economies have been difficult to achieve in new vehicle production, and the parts and components industry has tended to remain relatively undeveloped, tending to service the replacement market rather than the new vehicle market. In many of the developing countries, even this replacement market for parts and components has been seriously affected by the prolific importation of vehicles from all over the world (Doner, 1993). In Kenya, for example, KMI (1990) reports that upto three hundred different makes and models ply the roads, fifty seven of these assembled in Kenya by three vehicle assemblers. Evidently, the result is a vicious cycle affecting local sourcing of parts and components, where the supplier base continues to be weak (Masai, 1991), resulting in input market failure. Thus, assemblers are discouraged from local sourcing.

In production organisation terms, the Western and Japanese motor industries are founded on the principles developed, tested and disseminated by Henry Ford with his Model T, and Alfred Sloan of General Motors after World War I. Indeed, the philosophy and principles of mass production moved the world from centuries of craft manufacturing to mass production. Institutional, social, and political structures changed to reflect the changes in work patterns, and work relations. Mass production became synonymous with 'Fordism', which in turn became synonymous with large size and scale economies. In turn, based on traditional economic principles, any inter-firm relationships were, and have continued to be, based on cost minimisation and profit maximisation achieved mainly through high volumes and long production runs. As the practice of mass production became more familiar to manufacturers large corporations were formed, and most requirements were internalised in these corporations. These explanations of the development of mass production indicate that for various reasons, external transactions were cautiously used. In the recent past, however, this production organisation has altered. The increased search for higher productivity and efficiency are altering the way firms in the industry organise themselves for productive activities, and in the process altering industrial structure. These changes are not only taking place inside firms, but also in the relationships between firms, and in the macro-environment.

#### **4.2.3 RESTRUCTURING OF PRODUCTION ORGANISATION IN THE MOTOR VEHICLE INDUSTRY: SOME ISSUES**

It is widely documented that in search of competitive advantage, and as a strategy for survival in a hostile environment, firms are changing their strategies at the organisational level (Hoffman and Kaplinsky, 1988; Kenney and Florida, 1993). Various studies note the increased flexibility of firms (Kaplinsky, 1988) and the adoption of 'flexible' production techniques such as JIT, TQM, as



well as simultaneous engineering (Womack et. al., 1990). Consequently, the manufacturing, organisational structures, and human resource management approaches have changed to introduce flexibility in order to increase productivity. This in turn has led to increasing inter-firm dependencies as firms use more external sources for outputs. Although changes at the macro-level are, less obvious (Kaplinsky, 1988), the importance of national efficiency rather than merely plant level efficiency are recognised. In Europe and America, there are changes in the incentive system to encourage firms to adopt lean production (Hirst and Zeitlin, 1991). They argue, for example, that national policies are important in providing the right signals for firms to adopt new production approaches.

Hence, by changing the production paradigm, Eiji Toyoda and Taiichi Ohno of Toyota Motor company have triggered changes in social, political and production activities and the institutions which run them (Womack et. al., 1990). In simple terms, their production techniques introduced a system of production organisation which differed significantly from the western mass production model. While the paradigmatic framework has come to be known as 'flexible production', the production organisation has come to be known in western literature as 'lean production' (Womack et. al., 1990). It should be noted at this juncture, that these terms have generated considerable controversy regarding the theoretical argument about the flexible specialisation paradigm (eg. Pollert, 1988). Although acknowledging this controversy, this study does not intend to analyse the soundness of their theoretical basis as it is beyond its scope. Rather, it proceeds from the point that changes have certainly taken place, and firms are more 'lean' and are more 'flexible' than they have been. Firms have fragmented, de-scaled, and increased their dependence on inter-firm relationships as part of their competitive strategy.

As a result of the above changes, and in response to altered demand structures in many industries,<sup>13</sup> production organisation and inter-firm relations in the sector have altered. It is within this framework that, a growing body of Japanese and European literature highlights the changes in the production and labour processes of the sector to more flexible forms of organisation. Its main thrust is the thesis that there is potential for productivity increases derived from restructuring production activity. This literature particularly focuses on lean production as a strategy for increasing productivity by controlling costs, using Japanese production and management techniques such as just-in-time sourcing systems, flexible production, automation and robotization, total quality management techniques, continuous product and process improvement and flexible labour processes.

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<sup>13</sup>. Hoffman and Kaplinsky (1988) offer an interesting discussion of the changing rank ordering of preferences in the automobile industry.

Arguably, therefore, the general restructuring in the motor vehicle industry accounts for most of the inter-firm linkages occurring in that industry as firms scale down and use subcontractors more. Thus, the central elements of this new production organisation can be summarised at various levels: market fragmentation and model proliferation compel firms to use reflexive strategies; production organisation restructuring and changes in sourcing activity; spatial economies and location of suppliers; and the nature of competition.

### *Market fragmentation and model proliferation*

The genesis of restructuring of production organisation in industry in general is the fragmentation of markets in the face of shifting tastes (Bessant, 1991; Hoffman and Kaplinsky, 1988), and proliferation is a consequence of this variety and shifting nature of customer tastes. Although this development has had positive implications for the restructuring of the motor vehicle industry in developed countries where the industrial infrastructure is developed sufficiently to cope with the high levels of variability expected as a result of variability in consumer tastes, it has had a somewhat negative impact in developing countries.

Writing about the South East Asian countries, Doner (1993) argues that model proliferation has been a challenge to the motor industries of these countries as "...numerous, rapidly changing models [have] led to market fragmentation in most LDCs' auto industries. The large number of assembly plants results in tremendous excess capacity." (p409) He also cites a similar situation in the case of the Latin American automobile industries as discussed by Jenkins (1977). In Kenya, Masai (1991) and Coughlin (1988) have associated the decline in the parts and components supplier base with the makes and model proliferation, arguing that with such a proliferation, it is difficult for assemblers to achieve scale economies and for suppliers to acquire adequate skills for quality improvement. Consequently, there has been a repeated argument for rationalisation of the vehicle industries of most developing countries, while recognising the political and social dangers of restricting the society's access to goods and services. This is coupled with the realisation that those involved in auto assembly in developing countries have sufficient political influence to resist exclusion of particular makes and models, even in small market niches. Arguably, such small markets should atrophy through natural market forces. However, as Doner (1993) points out this is not the case. Even the Japanese manufacturers in Asian countries cling tenaciously to such low volume market niches due to their rivalry with other firms, a belief in the long term Asian auto markets, extensive financial reserves, adoption of new technologies to fragmented markets, and cross financing from high-volume/high profit to low-volume/low profit models. Clearly, market fragmentation and model proliferation in developing countries does not serve to promote supplier development as it limits the extent to which local suppliers can accumulate adequate experience and specialisation to meet the quality standards required by buyers.

In Asian countries, these problems have been addressed by attempting to expand the scale of production through assistance to supplier firms, or reduce capacity under-utilisation. Doner (1993) states that this has been done, largely, by imposing limits on the number of makes and models, and the frequency of model changes; and/or promoting the standardisation of parts among different models and/or brands (standardisation). The levels of success vary greatly. South Korea is reported to have been the most successful, followed by Malaysia, Thailand and Indonesia, and lastly the Philippines. Doner explains this as a function of state intervention in varying degrees. He hypothesises that, for example, in the South Korean case, "success is due less to state-imposed directives than to a complicated bargaining process between state and private sector" (Doner, 1993:409). This implies that mandating alone is not an adequate strategy for dealing with problems facing the sector. In Malaysia, on the other hand, although success has come more recently, its efforts "were undermined by the state's own need to provide economic opportunities for Malay capital. Ethnic politics took precedence over efficiency, and this meant allowing new Malay entrants into the assembly sector" (Doner, 1993:409). In Thailand, the Philippines and Indonesia, pressure from influential assemblers makes a mockery of state imposed limits on makes and models, despite support for those limits by local parts firms and some assemblers. Consequently, officials have reverted to quasi-market strategies where the increasing costs of localisation drive out those makes and models with low volume sales. Three major faults of this approach to localisation can be identified: it assumes that localisation can take place without first limiting makes and models; it supposes that all foreign assemblers are sensitive to the costs of localisation; and neglects the domestic political costs of excluding influential entrepreneurs. (Doner, 1993). Clearly, therefore, decisions about sourcing are not simple, rational choices about the most cost efficient alternative strategy. Rather, they are about political choices by various actors in industrial sectors. This contradicts Williamson's (1975) contention that cost minimisation is the primary motivation for inter-firm linkages.

This latter scenario is similar to that reported in Kenya. The short-termist attitude of some franchise holders makes it difficult to control the makes and models coming into the country (KMI). The demand for imported second-hand vehicles, has made it even more difficult to implement a rationalisation programme. Thus, the statist thesis for the control of makes and models is valid - a strong state is a vital requirement for rationalisation, but it must be supported by large business groups which in part promote their own efficiency, initiate model limits, and encourage standardisation of parts and components to serve their own needs. It must also recognise

the importance of conducive national ruling coalitions.<sup>14</sup> In the Kenyan motor vehicle industry, for example, the decision-making power of the importer/distributor category (see chapter five) make it imperative that their commercial objectives be incorporated in any rationalisation strategy as their returns depend on 'spreading' their scope into as many market segments as possible.

In summary, although the fragmentation of markets is often cited as a precursor to lean production or flexible production in developed economies, it has apparent detrimental effects on the general development of their motor industries. On the other hand, it can be argued that it is precisely these fragmented markets that would make it easier for developing countries to adopt lean production organisation much more easily than developed countries which have had to change their orientation from mass to flexible production. Developing countries can build fresh structures which incorporate this dis-aggregated approach to production organisation by developing industries exclusively based, initially, on SMEs and assisting these to expand. It must be noted, however, that it is this same fragmentation which is likely to restrict the extent to which external suppliers can be used, since, if they exist at all, they are themselves likely to be 'underdeveloped'. Clearly, this raises the question of the wisdom of developing the motor vehicle industry in other developing countries with similar characteristics. So far, the only logical explanation is that of economic nationalism. Arguments of efficiency are not necessarily relevant at this stage, hence, the costs of localisation are likely to be high.

### *Production organisation*

As stated in the opening paragraphs of this chapter, an important development in the restructuring process is the new form of production organisation adopted to meet the changing demand patterns. The first reaction to market fragmentation by Western vehicle manufacturers was to automate to allow producers to deal with the high variety and high quality demanded by consumers. More recently, they have combined automation and new organisational forms to achieve even higher flexibility (Womack et. al., 1990), an approach already used by the Japanese in their motor vehicle industry. Particularly interesting for this study are the quasi-integration strategies, such as joint ventures, strategic alliances, franchising, licensing, and asset ownership contracts, which allow

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<sup>14</sup>. For a discussion of the various coalitions pertinent in Asian countries, see Doner (1993:414). The Phillipino case outlined here closely resembles the Kenyan case. The importance of foreign capital in Marco's ruling coalition was too great to allow the exclusion of foreign assemblers when he attempted to create the Phillipino version of the Japanese *Zaibatsu* (Supplier co-operatives). Kenney and Florida (1993:151) document the formation of a similar kind of co-operative in the USA - the Bluegrass Automotive Manufacturer's Association (BAMA), which was formed by Toyota in 1990 to help create a state-of-the-art JIT supplier infrastructure for the company's Georgetown, Kentucky, assembly operation.



managers to access inputs and markets at lower capital costs, but offer greater productive flexibility. Such mechanisms allow managers to exchange certain goods, services, information, or expertise while maintaining formal trade relationships with others. In addition, the firms concerned can retain their separate corporate identities while avoiding antitrust prosecution.

Production re-organisation has also taken place at the level of technology, consequently affecting work organisation. The division between R&D and the operational functions of the organisation have long defined the limits of inter-function interaction. Product improvement was the function of the R&D department, which in turn depended on the quality control departments (Kaplinsky, 1988). With restructured production, this distinction has become obscure as firms buy in R&D from other firms. In the UK for example, small technology firms provide a substantial proportion of technology to large firms through strategic alliances and partnerships (Forrest, 1990). In addition, the JIT system of inventory management and related concepts of 'zero defects' bring the activities of manufacturers and suppliers closer than they have been before. Quality control has, therefore, become ubiquitous in the whole production chain, and buyer-supplier relations have had to become even more 'intimate'. This theme is followed up in the the subsequent section. Additionally, because quasi-integrated organisational forms of production are now used, 'employees' concerned with any particular process could be scattered over several firms and geographical areas, again, reinforcing the need for closer co-operation between suppliers and buyers.

### *The nature of buyer-supplier relations*

Changes have also occurred at the level of inter-firm relations since firms need to rely on outside suppliers due to the changed forms of production. Kenney and Florida (1993) for example, give an account of how joint ventures and subcontracting relationships have increased in the American motor vehicle industry as a result of JIT techniques being adopted by American and Japanese transplant manufacturers. They cite the results of a survey by a leading automobile trade journal which found that 57% of all automotive suppliers are involved in joint ventures with vehicle manufacturers. Consequently, mutual dependency has become important. However, this is predicated on the existence and the quality of the supplier infrastructure. The Japanese supplier infrastructure in the motor vehicle industry was developed alongside the activities of the major vehicle manufacturers (Smitka, 1991). Hence, the use of external suppliers has not been limited by a limited supplier base. In the USA, although despite a well developed supplier base in the parts and components industries, they have not been specifically linked to particular vehicle manufacturers. On the other hand, the Japanese transplants in the USA have promoted specific relationships with suppliers by 'building' a tier of suppliers for their specific needs (Kenney and Florida, 1993). As will be seen later, this is has been less the case in developing countries.



In the West, changes in buyer-supplier development are moving away from arms length contractual relations (ACR) to the obligational type of contractual relations (OCR) described by Sako (1992) in her schema. The important elements in this schema are the level of trust, which is executed through a higher level of information exchange and 'trusting' behaviour such as single sourcing; technology transfer; and risk sharing. Kenney and Florida (1993:141) report, for example, that in the US motor vehicle industry, "[Japanese] transplant suppliers share information and interact with assemblers", on design, production techniques and quality control. They add that "transplant assemblers also work closely with equipment suppliers to ensure that both assembly-line machinery and processing equipment are tailored to their needs" (p142). In the UK, Turnbull et. al. (1992) note a similar approach by the Japanese transplant Nissan, while the indigenous British firm Rover still uses arms-length relations. Clearly, inventory management considerations have meant that buyers and suppliers have to work as closely as possible in order to achieve maximum benefit.

### *Spatial economies and location of suppliers*

There have also been changes in the relative importance of the spatial location of suppliers. Kenney and Florida (1993) argue that the extensive dispersal of US Automotive Components suppliers, for example, has been a consequence of the arms-length character of Fordist supplier relations which emphasise low cost and disregard proximity. Consequently, suppliers are selected on the basis of price which covers all related costs. In the UK, Turnbull et. al. (1992) attribute these to the "ethos of short-term, competitive relations"(p166). On the other hand proximity and density of suppliers are considered important for JIT which characterises the changes in production re-organisation. Casumano (1985) notes, for example, that Toyota in Japan has had more success than Nissan with its JIT implementation because its customers are closer, and more concentrated. At Nissan (UK) for example, a different pattern emerges. Out of 198 suppliers in 1992, 130 were from all over the UK, 29 from Germany, 13 from France, 11 from Spain, 3 each from Belgium and Ireland, and one each from Austria, the Netherlands, and Switzerland. Even those located in the UK were widely spread in the country. Despite being located in the North East of England, 46 of its suppliers in 1992 were from the Midlands, 26 from the North East, 23 from the South East, 19 from Wales, 9 from the North West, 6 from Yorkshire, 4 from Scotland, and 1 from Ireland. Clearly, the proximity thesis for JIT implementation stands to question. One likely explanation is the advanced communication infrastructure in Britain and Europe, allowing frequent deliveries.

Another angle to the argument is that although spatial proximity is important in inter-firm relationships such as subcontracting,<sup>15</sup> and JIT, the proximity to final markets is even more important. Segments of the vertical integration literature argue that firms have often integrated because they believe that they can derive economic benefits in those stages of production where there is a high value added - usually in the forward stages closer to the customer. However, it is not the closeness to the customer, or the high value added which are important. What matters is the economic surplus - the return in excess of full costs of being in the business, including a fair return on capital (Stuckey and White, 1993). Closeness to suppliers or customers may satisfy this condition, but can only do so if the potential for combined value derived from supplier, as well as consumer proximity is exploited. The Japanese approach to production organisation is based on economic surpluses rather than on closeness to customers *per se*. Consequently, for example, while frequency of delivery required by the JIT production approaches are important, suppliers are not limited to a particular spatial location although this is the current mode of organisation. The use of multinationals and the increasing use of transplants in other countries demonstrates that value lies in the combined proximity of consumers and suppliers. The most important factor facilitating JIT is, therefore, an efficient communication system - transport infrastructure, telecommunication, and an efficient internal organisational framework for information exchange.

The question of the proximity of suppliers, and its relationship to the quality and performance of a supplier, has particular relevance for developing countries. Given the poor nature of infrastructure in many of these countries, suppliers would necessarily want to locate near assemblers if the JIT system, or any other form of production organisation which requires outsourcing, is to be efficient. According to Ramirez (1993), in Mexico, for example, the relationships between assemblers and suppliers have changed the national geography through the spatial restructuring taking place around production plants. The Ford Hermasillo plant requires many suppliers to make two deliveries a day, and given Mexico's transport system, and the fact that suppliers are fined \$20,000 a minute for delays which cause stoppages, many suppliers have located near the plant.

### *The nature of competition*

In industrialised countries, changes have also occurred at the level of competition. The basis for competition has changed from price to quality and product differentiation. Consequently,

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<sup>15</sup> Some geographical literature argues that suppliers have tended to locate close to their buyers. However, the advantages of proximity due to savings in transportation and storage, are not primary to sourcing decisions. Nissan car manufacturers in Sunderland, Washington, for example, have suppliers from all over Europe, but still use the JIT system of procurement. Bethlehem (1993), for example, argues that proximity to customers might be more primary. He gives an account of the paper industry as locating near the customers rather than near the pulp processing regions.

competitiveness measured by the value delivered to the consumer, and also the extent to which a firm can access a large number of market segments. In addition, because of the longer-term financial outlook in the lean production paradigm, market share expansion is based on product diversity (niching) rather than on extensive market coverage using lower-priced undifferentiated products. As already noted in preceding chapters, two common themes important to this thesis run through these changes. The emphasis on flexibility in response to the breaking up of mass markets and subsequent market segmentation. Competition is therefore on the level of scope, and ability to serve as many market niches as possible. Consequently, high product differentiation is demanded by the nature of the market. Secondly, the growing importance of the dis-aggregated organisational components of production imply that the organisation has to re-structure to deal with such high differentiation. These changes fundamentally recognise the primacy of organisational change in addition to the changes taking place at various levels of productive restructuring (Kaplinsky, 1988).

At inter-firm level, because of the need to control inventory costs and to outsource, the efficient use of outside suppliers has become imperative and competitiveness is defined by the access to good quality, reliable suppliers, or denying competitors access to such suppliers (Porter, 1985). Hence, merely having more efficient production techniques is not enough for competitiveness. It has become important to have more efficient relationships with suppliers of inputs and distributors of outputs. The importance of the whole of the supply and distribution chains are emphasised. Consequently, as noted above, the buyer-supplier relationship is increasingly changing from an adversarial one based on price, to a co-operative one based on collective competitiveness through customer satisfaction (and resultant loyalty). For example, in the Japanese model where 'zero defects' means that the supplier has to work closely with the buyer in order to achieve the quality and delivery standards required, short-term cost minimisation is not important. As Sako (1992) notes, buyers often 'invest' time and personnel in making sure that the supplier's product meets the quality standards required without any rejects.

In the western model, the concept of 'zero defects' does not exist. Instead, the quality of products is controlled at the end of the production process, often too late to make alterations. For the supplier, it is only the quality approved items which enter the buyer's production process. For example, Turnbull et. al (1992) note that in the UK, manufacturers have adopted 'bastardised' forms of JIT where warehouses are located close to the plant (eg. Rover at Cowley), timed deliveries made to the buyer's plant and invoices made only when parts enter into the assembly plant. Hence, the supplier has to bear the cost of defects in addition to the warehousing as well as inventory costs (Oliver and Wilkinson, 1988). The buyer is, therefore, unlikely to be interested in the problems causing such defects since the costs are most certainly borne by the supplier. Both the buyer and supplier are then left with no basis for bargaining, other than price.

However, although competition based on cost minimisation is important, it is not necessarily primary. Both the Japanese and European models assume that production organisation is aimed at increasing productivity and efficiency, hence, inter-firm relationships are seen as a function of these goals. Consequently, keeping the costs of the supplier chain low becomes one of the key elements for achieving efficiency and by extension, competitiveness. The main difference in the two models is that in the Japanese approach, competitiveness is seen in terms of the long-term benefits while the British model takes a short-term view to competitiveness (Sako, 1992). In developing countries, however, supplier chain efficiency may not necessarily be a valid motivation since one of the primary concerns of industrialisation is the localisation<sup>16</sup> of industry and capital. Inter-firm relationships, particularly between transnational corporations (TNCs) and local small and medium firms, are more likely to be affected by the political implications of resource ownership and control. Hence, keeping the costs of the supplier chain low are not as important as gaining access to and controlling resources. As noted earlier, due to uncertain economic conditions in many developing countries, firms have had the incentive to integrate as an assurance against endemic resource scarcity. In these circumstances, to encourage more inter-firm relationships, the state is more likely to mandate it.

There are obviously demerits to mandated inter-firm relationship formation, the most prominent being that in cases where the local supplier base is not established, as is often the case in developing countries, the competitiveness of the whole industry is limited. Mandating also leads to market failure as it affects the supply and demand of resources, and constrains markets, exacerbating and perpetuating the weak supplier infrastructure. Firms themselves are, therefore, more likely to be concerned with resource and market acquisition and control much more than with competitiveness achieved through cost minimisation. In other words, firms will not necessarily make purely economic decisions, but will make those which increase (or maintain) their power over markets and resources. In some developing countries, for various reasons, such cases are more common than they would be in developed economies such as Japan, the UK and America. For example, in the Kenyan case, the prevailing lack of penalties for excess capacity, coupled with the need to control scarce resources and markets, has allowed firms to grow beyond economically rational levels. In this environment, inter-firm relationships have been the exception rather than the norm.



In summary, this section has addressed some of the changes in the global motor vehicle industry impacting on inter-firm relationships. Arguably, these changes have accounted for the increase in inter-firm relations as firms seek competitiveness in the face of changing consumer tastes. Changes in production organisation have taken place on the levels of competition, production activity, and spatial location of suppliers, increasing the extent to which firms are inter-dependent. Consequently, the nature of buyer-supplier relations has also changed, generally moving to more obligational contractual relations, which inherently encourage closer inter-firm linkage. The following section explore further these relations by comparing the Western and Japanese approaches in the motor vehicle industry.

### **4.3 INTER-FIRM LINKAGES IN THE MOTOR VEHICLE INDUSTRY**

As noted earlier, in no other industry have inter-firm relationships been as extensively used or documented to the same extent, as in the motor vehicle industry. One explanation, which was advanced at the beginning of this chapter, is that the industry has been instrumental in the transition from mass to lean or flexible production organisation. This transition itself has increased the level of inter-firm dependency. On the other hand, it is the very nature of the process of the sector that could have made it possible to adopt the principles of 'flexible' or 'lean' production organisation. Apart from the service inputs, for example, Womack et. al. (1990:138) report that a typical vehicle model uses at least 10,000 different parts and components. Inter-firm relationships, therefore, seem to be a logical production organisation since no single manufacturer could possibly provide all of these requirements internally. It would appear, therefore, that the very nature of the technical process of vehicle manufacturing necessitates linkages involving several firms. This section examines the nature of inter-firm relationships in the Japanese and Western models.

#### **4.3.1 THE NATURE OF INTER-FIRM RELATIONS IN THE MOTOR VEHICLE INDUSTRY**

Despite the varied nature of inter-firm relationships in general, in the motor vehicle industry they have been documented largely, as contractual relationships taking the form of subcontracting (Tumbull, 1991; Casumano, 1985; Aoki, 1987), although collaborative relationships also exist (Bessant et. al. 1984; Dodwell, 1979). By definition, strategic alliances (or partnerships) are based on mutual need and co-operation (and mutual ownership of the activity in question), implying exchange relationships. Contractual relationships, on the other hand, imply that firms are more likely to pursue individual and separate efficiency advantages, emphasising cost reduction and profit maximisation. As discussed in chapter three, this kind of relationship is primarily founded on asymmetry (power-dependency) where one firm is dependent on the other for survival, with an implied superior bargaining power position of one partner. Chapter three also discussed Sako's (1992) useful schema which outlines the implications of these two approaches to inter-firm



relations. To recapitulate, Sako's schema argues that on one end of a spectrum of patterns of transactions, firms use arms length relationships with a pure contractual basis, while others use obligational relationships with an exchange basis. Other patterns lie along the continuum, exhibiting more or less of the characteristics of either extreme. Inter-firm relationships seem to have shifted from strictly contractual relationships to more collaborative ones as the nature of production organisation has changed. Earlier Japanese, and contemporary European inter-firm relationships are generally based on a purely 'arms-length' contractual philosophy (Minato, 1992; Turnbull, 1991). However, this approach changed significantly in Japan from the 1950s since Toyota's transition to JIT procurement systems. The Japanese approach to inter-firm relationships has changed to what is referred to as the 'co-operative' approach to inter-firm relations. What is seen today is a quasi-collaborative relationship between buyer and supplier.

#### 4.3.2 THE JAPANESE APPROACH TO INTER-FIRM RELATIONS IN THE MOTOR VEHICLE INDUSTRY

It is widely suggested that the high productivity levels achieved by Japanese manufacturers can be accounted for by the use of, *inter alia*, inter-firm relations. Hence, Japanese industry continues to offer, perhaps, the most prominent examples of inter-firm linkages, both of a specific and cross-industry nature. The Japanese themselves note that their industrial development has relied heavily on the linkages between large and small firms (Watanabe, 1971; 1972; Sako, 1992; Sato, 1989), particularly subcontracting. Watanabe has argued that in fact, the efficient use of small firms alongside large firms through subcontracting has given Japan its industrial prominence. In general, about 65% of all manufacturing firms in Japan enter into subcontracting relationships (Aoki, 1987). Similarly, the importance of the supplier network in the Japanese auto industry cannot be over-emphasised, where small and medium sized enterprises with fewer than 300 employees are particularly important in the lower echelons of the supplier pyramid (Dodwell, 1979; Trevor and Christie, 1988). The major corporations themselves account for a minimal proportion of the costs, but play a significant role of co-ordinating the production activities performed by a host of producers. In the Japanese motor vehicle industry, for example, Toyota and Nissan account for 25-30% of manufacturing costs of the vehicles sold under their nameplate (Casumano, 1985). The rest is paid to subsidiaries, affiliates, and subcontractors, hence the need for a close relationship between large and small firms in the industry. Basing his conclusions on comments by Fryer (1982), Turnbull (1991) proposes that it is because of this close relationship between large and small firms in the motor vehicle industry that Nissan enjoyed 30% cost advantage over Ford UK and British Leyland in the outsourcing of components in the 1980s.

Those attempting to draw lessons from the Japanese approach argue that Japanese competitiveness emanates largely, from supply chain management (Krafcik and MacDuffie, 1989). As noted in

preceding paragraphs, the Japanese automobile industry, considered the core of Japanese industrialisation, has exhibited some of the most innovative techniques and approaches to competitiveness, including just-in-time supply, long term collaborative contracts with a limited number of suppliers, flexible production organisation, and quality management of the production process. In addition, simultaneous engineering procedures, involving the concurrent production of designs, dies, and various parts and components, implies that several firms can work on the same 'project' at the same time thus reducing production time by upto half (Womack et. al., 1990). One of the central themes in simultaneous engineering is the need to share information from ideation to actual production of all parts and components, leading to close collaboration between buyers and suppliers. In effect, therefore, the focus upon inter-firm relationships, *inter alia*, can be said to result from the ongoing search for competitiveness in Japanese and European manufacturing. It would be expected, therefore, that motives of efficiency (and related cost reduction objectives) should predominate such relationships. Yet, evidence suggests that Japanese firms form and nurture relationships based on reciprocity and exchange (Minato, 1992; Sato, 1989; Sako, 1992), and a high element of trust between<sup>17</sup> buyer and supplier. In effect, the Japanese model 'blurs' the dichotomous divide between contractual and strategic alliances, where efficiency is sought collectively rather than at the expense of the other party.

Sako (1992) and others argue that the main thrust of relations in the Japanese 'model' is the interchange of information and a considerable level of 'trust' between buyer and supplier - the Obligational Contractual Relation (OCR). The basis of this relationship is mutuality of need, action, and dependency. The participants in the relationship feel mutual indebtedness or obligatedness at any time is a normal state of affairs which sustains a relationship (Sako, 1992). Womack et al. (1990) argue that this has been possible in the Japanese environment because

"a rational framework exists for determining costs, price and profits. This framework makes the two parties want to work together for mutual benefit rather than look upon one another with mutual suspicion" (p148).

Hence, according to Sako (1992) buyer-supplier relations do not only involve economic contracts covering the production and trading of goods and services, but are also embedded in more pluralistic social relations between trading partners who have a sense of mutual trust.

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<sup>17</sup>. Casson (1987:118) argues, on the other hand, that the form of trust prevalent in Japanese buyer-supplier relations is founded on the economic power of the buyer. In addition, the subcontractor may be required to supply the buyer exclusively, so switching costs to other buyers are high. The buyer also has several suppliers so that he cannot be held hostage by the withdrawal of suppliers. The short-term credits and a procurement service act as a further deterrent to client switching by a supplier. This is consistent with the profit maximisation of the client firm over a long-term horizon.

Consequently, the exchange of information and benefits highlights an environment of reciprocity. The inter-dependence which ensues, and the time span involved in this 'model' of buyer-supplier relations, are recurrent themes in the literature which seeks to contrast the Japanese and British (or indeed western) approaches to buyer-supplier relations.

#### 4.3.3 THE WESTERN APPROACH TO INTER-FIRM RELATIONS IN THE MOTOR VEHICLE INDUSTRY

On the other hand, the Western approach to inter-firm relationships, although exhibiting some elements of mutual dependency between firms, have been asymmetrical, and have been regarded by many authors as 'adversarial' in nature (Tumbull, et. al., 1992; Tumbull, 1991). As already mentioned, according to Sako (1992), this pattern is characterised by limited inter-dependence; limited information exchange; limited benefit sharing; and typified by 'short-term' contracts. The main thrust of the literature is that in Western inter-firm relations, the element of 'trust' is limited to 'contractual trust' (expectations that promises made are kept) or 'competence trust' (confidence in a trading partner's competence to vehiclery out a specific task), while 'goodwill trust' is minimised in order to avoid "heavy interdependence" Sako (1992:10). Arguably, this accounts for the 'adversarial' relations between buyers and suppliers, with cost minimisation at the centre of relationship negotiation. Clearly, this limits the frequency of the use of inter-firm relations.

European and American vehicle manufacturers have realised that in order to compete with Japan, they must adopt matching or better strategies in the industrialisation process. Comparing the Japanese and European automotive industry, Tumbull (1991) cites relative competitiveness of Japanese manufacturers. For example, Lucas Industries in the UK found that their Japanese competitor enjoyed 30-40% lower costs than their own typical engineering plants (Pamaby, 1987). In addition, Tumbull cites the results of Krafcik and McDuffie's (1989) study which showed that the average Japanese owned vehicle plant operating in Japan can produce a vehicle of comparable specification and complexity using half the labour input of the average<sup>18</sup> European plant and only a third of the least efficient plant. The same study also found that Japanese motor manufacturers consistently record superior (and improving) levels of quality while that of European motor manufacturers is static (Krafcik and McDuffie, 1989). Consequently, motor manufacturers in the UK and other European countries, in trying to meet these levels of competitiveness, have to recognise the need to improve their performance levels and to adopt strategies which give them comparable advantages in supplier chain management. In reaction to the Japanese challenge,

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<sup>18</sup>. Sections of western literature comparing Japanese and western performance object to the use of this as a basis, arguing that the Japanese industry is heavily dependent on supplier networks and therefore their output per employees is bound to be higher.

European motor manufacturers are emulating their production and management practices. 'Transplants' of Japanese firms dot the European map, and production techniques and resource management systems bear the Japanese label. In the UK automotive industry for example, the use of JIT procurement systems is increasing, and inter-firm relations between buyers and sellers are increasingly viewed as the primary vehicle for comparable levels of competitiveness already achieved by the Japanese. However, although firms such as Nissan (UK) are increasingly adopting Japanese buyer-supplier relations, for example by reducing the number of suppliers and getting involved in supplier development (Tumbull, 1991), this is not yet a widespread phenomenon among British firms.

Thus, although European manufacturers are also aware of the importance of cost management and efficiency, their approach is significantly different from that used by the Japanese. Western, particularly European manufacturers, have retained the old format which supports mass production, and are pre-occupied with cost control. According to Tumbull (1991, this is inadequate when trying to change production organisation. It is clear from the Japanese experience that manufacturing cost minimisation is not the whole story, but rather it is the combination of cost minimisation; human resource management; and continuous quality improvements which matter in addition to the firms' commitment to each other.

".....now need a step change in their manufacturing *performance* rather than incremental improvements in their manufacturing costs if they are to compete in the world or even domestic markets" (p169)

In addition, Western manufacturers view productivity improvements in terms of automation rather than in terms of changing their whole approach to input sourcing, production organisation, and distribution re-configuration. Authors such as Tumbull (1991) suggest that one of the major ways to compete with the Japanese is to

"reorganise the flow of work within their own assembly plants and between their assembly plants and external suppliers. ....In many respects, external relationships with suppliers are more important given that the unit cost performance of most manufacturing operations depends far more on the effectiveness of purchasing than on the close control of direct labour performance" (p170)

Yet, not all firms fully appreciate the importance of inter-firm sourcing. Auto manufacturers such as Austin Rover, in the UK admit that scheduling buyer-supplier relations is among the last area of manufacturing control to be refined in their programme of re-organisation and re-structuring (Bessant et al., 1984), although those associated with other Japanese auto manufacturers such as Nissan (UK) have made an effort to programme supplier relations. Even these, reports (Tumbull,



1991:172), "are still preoccupied with short-term financial performance, as illustrated by their focus on work practice reforms and attempts to intensify the work process in order to force up labour productivity."

#### **4.3.4 IMPLICATIONS FOR INTER-FIRM RELATIONS IN THE MOTOR VEHICLE INDUSTRY OF DEVELOPING COUNTRIES**

Due to their multinational status, manufacturing firms in developing countries are largely modelled on Western organisational forms, generally organising production along the principles of mass production. Consequently, inter-firm relationships are less likely to be used. While some ongoing research documents the transition from mass production to flexible specialisation in developing countries,<sup>19</sup> little is yet known about the specific elements of inter-firm relations in these countries, and even less about their vehicle industries. However, other factors affect the development of inter-firm linkages, the most prominent being the market failures brought about by, among other factors, the impact of state intervention on market mechanisms. Failures in input markets in developing countries (discussed in chapters four) have made it easier for firms to integrate rather than use external markets.

In developed countries, the availability and quality of suppliers is assumed. In developing countries, on the other hand, the supplier base has not developed at the same rate. One of the factors affecting the localisation of input procurement is the perceived 'quality' of the supplier base. The vertical integration literature argues that one of the main reasons for vertical integration by firms is risky and unreliable markets - market failure, affected by asset specificity, frequency of transactions, the number of buyers and sellers in that market, and the balance of power between them. When market failure occurs because of few buyers or suppliers, both parties experience a reduction in bargaining power. In addition, both parties are vulnerable to opportunistic recontracting. However, this very small number of suppliers raises problems of competitiveness for the buyer - the market for inputs is not sufficiently developed for the quality and product advantages to be realised. Although the localisation strategy has been used in developing countries

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<sup>19</sup>. See for example the work by Kaplinsky and Posthuma (1993) on the organisational changes taking place in Zimbabwean firms, particularly their use of JIT techniques. Some work has already been done on the relevance of flexible specialisation in Less Developed Countries (IDS Bulletin, 1992; Brighton). Ramirez (1993) also reports the findings of similar studies on the Mexican automobile industry.

<sup>20</sup>. Doner (1993) discusses a range of state support measures for small and medium firms. These include financial and tax incentives such as those used in South Korea to encourage the modernisation of this category of firms. He also cites the use of cartels, mandated frequency of payment of suppliers, reserved markets for small and medium firms, and the banning of prime contractors from buying SMEs through stock ownership.



to develop a supplier base, the conditions which encourage vertical integration continue to exist. In the Asian countries, for example, competition is undermined by collusion among foreign firms or by the restrictions on input sourcing in contracts between local suppliers and their foreign customers. The state has contributed to this market failure by mandating local sourcing and concomitant localisation levels (Mardon, 1990; Enos, 1984).

A second factor influencing localisation is 'deletion allowances'. When an assembler agrees to procure components from the host country, it must remove or 'delete' those components from the kit of knocked-down parts packed in the manufacturer's country. The deletion allowance refers to the price reduction of the kit after the localised parts have been removed. This, however, is rarely a simple deduction matter. It is often claimed by assemblers that the deletion allowances are too small, yet locally procured equivalents cost more. This makes vehicles assembled using local parts much more expensive than those without. In addition, in Asia it is alleged that low deletion allowances are used for transfer pricing. It is also claimed that most assemblers are consciously trying to raise the cost of localisation and discouraging local firms from investing in parts and components. Deletion allowances are smaller for critical components, and assemblers are in a solid position to suppress the deletion allowances for popular makes and models. (Doner, 1993). Similar conclusions have been made about Kenya's industry (Masai, 1991).

Assemblers can also hinder the development of local suppliers by withholding technical and financial support from them, either to justify their opposition to localisation, or to justify vertical integration. By failing to provide prototypes, technical training, sufficient lead time for new products or product changes, and favourable terms of payment, the uncertainty of suppliers increases (Doner, 1991). Evidently, this environment does not allow for co-operative relationships - it is still a zero-sum game. Yet, it is also evident from the Japanese inter-firm relations that a more co-operative relationship offers a better environment in which to promote mutually acceptable criteria for analysing costs, establishing prices, sharing profits and transferring technology (Womack et. al., 1990). For example, in the South Korean case, the pressure from a strong state helped to encourage assembler-supplier co-operation by promoting the suppliers through financing and training, and encouraging the formation of the Korean Automobile Industry Co-operative Association. However, the broader coalition arrangements were also important, mainly to prevent economic concentration after disruptive strikes in 1987-1988.<sup>20</sup> The strength of the supplier base is often evaluated in terms of product quality and supplier performance. Indeed

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<sup>20</sup>. Doner (1993) discusses a range of state support measures for small and medium firms. These include financial and tax incentives such as those used in South Korea to encourage the modernisation of this category of firms. He also cites the use of cartels, mandated frequency of payment of suppliers, reserved markets for small and medium firms, and the banning of prime contractors from buying SMEs through stock ownership.

assemblers in developing countries have claimed that they were willing to procure locally but the existing suppliers could not meet their quality standards and delivery specifications (Masai, 1991; Doner, 1993).

Arguably, however, the critical factors likely to influence the formation of inter-firm linkages in developing countries is the very adoption of lean or flexible production organisation as a precursor to inter-firm linkages. Kaplinsky and Posthuma (1993) argue that this is already in question as infrastructural inefficiencies endemic in developing countries potentially threaten the use of JIT techniques. In addition, state intervention in accessing markets and resources limits the extent to which firms can make rational decisions.

#### 4.4 CONCLUSION

This chapter has explored those factors affecting inter-firm relationships in the motor vehicle industry, highlighting the differences in the Japanese and 'Western' approaches to inter-firm relations, and suggesting that both approaches differ somewhat from the case in developing countries.

The western and Japanese approaches to inter-firm relationships presented above are both founded on the motive of efficiency and competitiveness (Friedman, 1988; Turnbull, 1991). However, in the Japanese illustration competitiveness is viewed as a long-term goal, requiring long-term synergies in the production process, hence the long range view of inter-firm relations. This approach also moves away from the assumptions made by the mass production organisation that cost minimisation and profit maximisation in the short-term are the main drives of the firm. Rather, it sees competitiveness as a function of restructuring of production organisation to ensure long-term effectiveness of input procurement - control.

However, both approaches differ from those found in developing countries. In assuming at least near perfect markets, both approaches also assume that the firm can make economic decisions about input procurement. Yet, to a large extent, some inter-firm relations are predicated on the external environment in which it operates. For example, government regulation and other forms of intervention are common reasons for market failure in developing countries. In addition, firms are affected by other factors such as the political/legal framework within which they operate, which make economic decisions inappropriate.

This chapter has highlighted the importance of several factors which are relevant for inter-firm relationship formation: firm specific factors including the economic, technical and strategic factors; external factors such as the supplier infrastructure, government intervention, and macro-

economic factors; supplier related factors, focusing on the performance of suppliers. In the next chapter, Kenya is discussed as a specific context of a developing country.

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## **CHAPTER FIVE**

### **KENYA: THE RESEARCH CONTEXT**

#### **5.1 INTRODUCTION**

In chapter one, the aim of the research was stated as the search for a strategy towards small enterprise development through linkages between large and small firms. Chapter two discussed the rationales put forward, in a variety of contexts, for developing small enterprises and highlighted the potential role of small enterprises as part of a network with large firms within an industry. This chapter has the main objective of elaborating on the rationale of the research in Kenya, and contextualising the study.

Although several of Kenya's development goals and strategies suggest that a dis-aggregation of production organisation is desirable, even necessary, its industrial policy favours large firms. As a result, large firms dominate industrial activity. In addition, although policy makers in Kenya are aware that the industrialisation process could benefit from current global de-integration of large firms, and the use of inter-firm relationships to supply requirements, little is known about how to motivate large firms to dis-aggregate and form linkages with small firms. Historically, firms in Kenya have had the political and economic incentive to integrate, regarding the premium paid for excess capacity as a reasonable consideration for the assurance against resource scarcity, and the weaknesses in the supplier structure. The question is how to encourage these inter-firm linkages in an environment where large firms are established, and dominate and condition the social and institutional structures in the economy.

This chapter outlines the context of the study, Kenya, in seven sections. The following section outlines the research problem, highlighting Kenya's development goals and strategies which suggest that Kenya desires to restructure its industry, particularly by promoting small enterprises, but also recognises that the current dominance of large firms may prevent it. The third section briefly discusses the effects of the dominance of the large scale enterprise sector, while the fourth examines the current status of small enterprise development in Kenya. The fifth section discusses the status of large firm - small firm linkages in Kenya, while the sixth section outlines the structure and activities of the country's motor vehicle industry, the context within which the study was formulated. The seventh section summarises the chapter.

## 5.2 KENYA'S DEVELOPMENT GOALS AND STRATEGIES

Africanisation of the economy and its political structures and institutions has become Kenya's long-term and most recurrent development theme. At independence from colonial rule in 1963, Africanisation was seen as a confirmation of political independence, and a platform for economic independence. Consequently, the latter has been pursued relentlessly as an assurance against neo-colonialism by way of economic and technological dependence. Large foreign firms continue to be viewed as a potential vehicle of perpetuating economic dependence. It is within this framework that Kenya's *Sixth National Development Plan (1989-1993)* and preceding policy statements argue that industry and commerce must be Kenyanised in addition to the government's reduction of direct investments in industry and commerce. The plan recognises that

in terms of turnover, the manufacturing and trading activities of non-Kenyans who make up less than 2% of the population now constitute more than 65% of the total.(p152)

To address the broad goal of Kenyanisation, more specific goals and strategies have been adopted, among them: ownership restructuring of industry; technology development and transfer; capacity utilisation and resource use; reduction of monopolies and industrial concentration; and privatisation of state corporations. All of these goals and strategies have the potential of Kenyanising the economy through various forms of restructuring, dis-aggregating production organisation, and encouraging linkages between existing large and small businesses. The following discussion puts these in perspective.

### 5.2.1 OWNERSHIP RESTRUCTURING OF INDUSTRY

Ownership restructuring has continued to focus on addressing two issues: reduce government investments in industry and commerce; and increase ownership by indigenous Kenyans. Kenya's *Sixth Development Plan (1989-1993)* sees such restructuring as the "only way through which nationals will graduate into the competitive system where they can participate on an equal footing with non-Kenyans" (GOK, 1989:153), aiming to achieve this through small enterprises. Sessional Paper No 1 of 1986 (GOK, 1986) outlines the various arguments for the adoption of the strategy, namely: (i) for various reasons, a large proportion of indigenous Kenyan capital is employed in the small enterprise sector, hence the argument for restructuring industrial production to include the lower levels of investment; (ii) small enterprises use local materials, hence they are likely to reduce Kenya's import bill; (iii) Small enterprises are likely to create more jobs at a lower cost; (iv) large enterprises are mainly foreign owned, increasing dependency on foreign capital and technology.

At the same time, foreign firms have been viewed as contributing to the continued capital flight through repatriation (Kaplinsky 1978, 1988) and transfer pricing (Nyong'o, 1988; Kaplinsky, 1978; Coughlin, 1988c; Owino, 1985). The Kenyan Government might be expected, therefore, to favour the creation of an indigenous capitalist class to supplant foreign capital and reduce capital drain while at the same time encouraging indigenous Kenyans to participate in the manufacturing sector.<sup>21</sup> Yet, the proportion of foreign investment has remained higher than indigenous capital outside government investments in manufacturing.<sup>22</sup> While the ownership structure continues to be foreign-capital heavy (Vaitsos, 1991), and the emergence of large and medium scale African industrialists in Kenya slow (Kaplinsky, 1982:209-11),<sup>23</sup> multinational corporations (MNCs) appear reluctant to invest further in Kenya (Coughlin, 1991a). One of the reasons suggested is the continued fear of displacement as a result of the Kenyanisation programme.

In an effort to prevent any perceptions of displacement by small or large firms, the *Sixth National Development Plan* (GOK, 1989), was careful to add that the government's intention to tackle these problems had "to be understood in terms of efficiency in the use of resources" (p152) rather than merely as a strategy to eliminate foreign investors.

In addition, because of suggestions of fears of displacement expressed by foreign investors, it was necessary for the government to assure large investors that

"the thrust of the Kenyanisation strategy is, therefore, to increase the participation of local people in various activities of the economy. It does not imply denying non-Kenyans effective participation in the economy. On the contrary, it is consistent with the need to enhance entrepreneurial development and expanded investments in the country." (p153)

Thus, restructuring is considered by policy makers to be a tool of industrialisation management rather than as a mere political tool to 'displace' large foreign investors or to promote indigenisation at the expense of industrial development.

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<sup>21</sup>. Local entrepreneurs are also likely to have contributed to capital flight in search of better investment prospects elsewhere.

<sup>22</sup>. Kenya has over 200 Multinational Corporations from Britain (investment of £1500m), USA (\$260m), Germany (\$60m), and other countries (\$10m). Only about half of these have Kenyan partners or have government shareholding.

<sup>23</sup>. Kaplinsky (1982) notes that in 1966, 60% of Kenya's capital was controlled by foreign investors while in 1976 this had gone down to 43%, being replaced, principally, by public investments.

A second rationale for restructuring ownership of industry is the privatisation of public investments and dismantling of the state's involvement in commerce and industry. Together with the large-scale firms, the state has continued to own a large proportion of industry and commerce through various types of parastatals. At independence in 1963, this was seen as the only way economic resources could be transferred into the hands of indigenous Kenyans who were perceived not to have the financial and managerial capacity to enter into business as private individuals (GOK, 1965). The recent privatisation drive (partly due to external pressures and partly due to internal desire to improve efficiency), aimed at reducing the operations of state enterprise and increasing the efficiency of government operations as part of the Structural Adjustment Programmes, has necessitated a re-orientation from state investment to private sector ownership, and from large to small organisations. The government views this as one opportunity for indigenous Kenyans to enter into the mainstream of industrial development through stock ownership or through trade links with privatised organisations (GOK, 1989).

The indigenisation rationale has provided, therefore, a powerful impetus for the promotion of small firms in Kenya.

### 5.2.2 TECHNOLOGY DEVELOPMENT AND TRANSFER

Another pertinent goal is that of technology development and transfer. Again, since independence (1963), Kenya's development plans emphasised the importance of science and technology for social and economic development.<sup>24</sup> Yet, largely due to a weak indigenous technological base brought about by the colonial legacy, Kenya has continued to rely on external sources for technology, largely through MNCs and foreign owned organisations. This has continued to be reflected in the economic structure (Juma, 1991). In the early stages of Kenya's industrialisation, the import substitution strategies meant that technological inputs tended to concentrate on imported capital goods, knock-down components for domestic assembly, intermediate goods for domestic processing plants and packaging of finished goods (Leys, 1975). As a result, over the years, the indigenous technological base has not grown.

Government documents, such as the *Sessional Paper No.1 of 1986* and the *Sixth Development Plan* (1983-1989) suggest that one strategy for fast acquisition and transfer of technology is the transfer of technology from foreign to local investors, and from large to small enterprises (GOK,

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<sup>24</sup> In a programme aiming to propel Africa into economic development, Africa Priority Programme for Economic Recovery - APER 1986-1990- the Organisation of African Unity (OAU) recommended an investment of at least 1% of GDP in technology if Africa was to catch up with the rest of the world in terms of economic development. Kenya adopted this 1% recommendation.



1992) through subcontracting relationships, partnerships and joint ventures. Yet, in practice, incentives for technology transfer from large to small firms have neither been adequately articulated nor followed up by policy makers (Coughlin, 1991c). Writing about the factors contributing to slow industrialisation in Kenya, Coughlin (1991c) succinctly sums up the situation:

"The policies and institutions affecting technological development in Kenya's manufacturing sector have evolved disjointedly..... as a result, Kenya does not have a systematic and comprehensive policy to govern the transfer of technology and to guide the development of local technological capability" (p 3)

Consequently, many of the partnership agreements meant to implement these policies have not been fully implemented, and little technology transfer has occurred (Ebangit, 1985). Moreover, "Kenya has no systematic mechanism for vetting technology transfer agreements ..." (Coughlin, 1988c:286). Hence, while aspiring to encourage technology transfer from foreign owned to local firms, and from large to smaller firms, Kenyan planners have failed to institute the right machinery and incentives to achieve this goal.

### 5.2.3 CAPACITY UTILISATION AND RESOURCE USE

Like most developing countries, Kenyan industry is characterised by excess capacity (World Bank, 1987:52), much of which is caused by vertical integration of firms as a buffer against resource and information uncertainties. Although Kenyan planners are aware that for the country's potential to be fully utilised, its productive capacity must be fully used, low levels of capacity utilisation are reported. In the *Fifth National Development Plan 1983- 1988*, it was noted that:

"The productive capacity of a nation, whether in the public or private sector, is a resource whose potential must be more fully realised than present if the pace of development is to be improved ..... An important effect of drawing the nation's under-utilised capital stock more fully into the mainstream of national development is that much additional employment will be created in the process" (GOK, 1983:50-51)

Yet, according to Coughlin (1985), Kenya utilises, on average, about 34% of her industrial capacity, although some industrial sectors show a significantly lower level of utilisation (see *Table 5-1*).

Kenya's low capacity utilisation in manufacturing has its origins in the historical development of its industry. First, Kenya's industry was based on Multinational Corporations, most of which were fully integrated. Secondly, as was noted above, because of uncertain business environments inherent in developing economies at the time, firms which located in Kenya soon after independence felt the need to control resources through vertical integration. They are likely to have

viewed vertical integration as adequately offsetting the premium paid by holding excess capacity. Finally, large size had a political advantage as it was important in bargaining with the government on the basis of employment contribution. However, as times and conditions have changed, this pattern seems to have continued, yet the need for enterprise and national competitiveness calls for different strategies.

Other related explanations for capacity under-utilisation in Kenyan manufacturing industry have been hypothesised in the literature. These include low demand levels (Owino, 1985); lack of consistent government planning for capacity installation and utilisation (Owino, 1991); supply bottle-necks causing shortages of materials, energy, trained manpower and infrastructure leading to "hoarding" of capacity (Kerre, 1991); lack of consolidation of the domestic market through protection (Owino, 1991); the licensing of imports thus posing excessive competition for some industries and encouraging them to adopt defensive strategies by 'hoarding' capacity (Owino, 1991); inadequate co-ordination among inter-dependent industries (Kerre, 1991); and the continual threat of increase in the prices of plant and equipment which leads to anticipatory installation.

#### 5.2.4 REDUCTION OF MONOPOLIES AND INDUSTRIAL CONCENTRATION

As part of its strategy to revitalise the economy, restructure the ownership of industry, open up markets to increased competition as well as enable indigenous Kenyans to own productive resources, the Kenya government has tried to restrict vertical integration of firms by adopting The Restrictive Trade Practices, Monopolies and Price Control Act (1988). While this piece of legislation can achieve structural changes in industry, the government has not had an adequate implementation and policing mechanism to achieve the intended results. Loopholes continue to exist, and firms continue to integrate since the incentives for doing so still exist in the business environment.

The development goals outlined here provide a policy justification for using large firms as a platform for small enterprise development. They suggest that there is a political will to promote dis-aggregation of industry. Collaborative rather than adversarial arrangements between large and small firms have the potential to foster technology transfer. Further, internal restructuring of various firms forced to disintegrate in response to policies which control monopolies, and the privatisation of state corporations, have the potential to foster small firm birth and growth as dis-aggregated firms seek suppliers in the open market; and also through increased competition in the market as firms move out of some sectors. Finally, as firms concentrate on core activities and source externally those inputs and activities which they consider to be non-core, a higher capacity utilisation can be achieved. The question is how to motivate large firms to source primarily from small firms as suppliers of products and services, particularly in an environment where firms still

**Table 5-1 Capacity Utilisation Levels for Selected Manufacturing Industries**

Industry (or sub-sector)	Capacity Utilisation %*
Foundries <sup>1</sup>	23%
Metal Engineering Workshops <sup>1</sup>	35%
Plastics processing <sup>1</sup>	53%
Handtools and Cutlery <sup>1</sup>	22.9%
Pharmaceuticals <sup>1</sup>	21%
Textiles and Clothing <sup>2</sup>	96%
Food Production <sup>2</sup>	89%
Electrical <sup>2</sup>	42%
Iron and Steel <sup>2</sup>	56%
Chemicals <sup>2</sup>	86%
Paper and Wood Products <sup>2</sup>	93%
Leather and Footwear <sup>2</sup>	53%
Beverages and Tobacco Products <sup>2</sup>	75%
All Manufacturing Firms*	34%

<sup>1</sup> These figures are adopted from Owino (1991) citing various studies including Coughlin, 1985:172; Mwangi, 1984:159; Kerre, 1985; Owino, 1985; ILO, 1972. All of these are culculated on a one shift basis.

<sup>2</sup> These figures are actual capacity utilisation figures from a World Bank (1987:52) report on Kenya's industrialisation.

\*This figure is given by Coughlin (1985), and is not an average culculated on the figures in the table. A UNIDO (1986) study gives an average of 32%; while the World Bank (1987) study gives an average of about 80% over several industries. The studies are not explicit about the shift basis of these utilisation culculations. All studies are based on installed capacity utilisation rates.

this dominance of large firms, and not enough small and medium enterprises. A World Bank report (1987) concluded that Kenya's industrial development and the manufacturing sector<sup>25</sup> are considerably adversely affected by the weaknesses apparent in the small enterprise sector.

"a major weakness of Kenya's industrial development .....[is the] paucity of modern small scale manufacturing establishments" (p210).

The population of large firms in Kenya's industrial structure is relatively small. To illustrate this, Table 5-2 indicates Kenya's size distribution of firms in manufacturing in 1988 and 1990. It is important to note that this includes only those firms which enter the national statistics. This implies only those formal registered firms in the economy. The informal and micro-enterprise sector tends to have limited 'visibility' due to 'informality' or non-registration. However, these figures provide an indication of the structure of the manufacturing sector.

**Table 5-2**      *Size Distribution in Manufacturing (1988 and 1990)*

Firm Size (No of Employees)	Share of Recorded Firms (1988)	Share of Recorded Firms (1990)	Share of Recorded Firms - Total Economy (1988)
0 <sup>a</sup>	16%	8%	21%
1-4	17%	18%	25%
5-9	11%	12%	13%
10-19	14%	16%	15%
20-49	17%	16%	11%
50+	25%	31%	14%
<b>Total</b>	100%	101% <sup>b</sup>	99% <sup>b</sup>

*Notes:*

<sup>a</sup> Zero employees means owner-managed firms with no employees recorded

<sup>b</sup> Does not add up to 100% due to rounding error

*Source:* Statistical Abstracts (1989; 1991) - Kenya (GOK)

<sup>25</sup> Kenya's industrial output has grown slowly, averaging 4.7 % p.a. 1978 and 1988. Value added in manufacturing grew by an average of only K£100m per year from K£391.04m in 1982 to K£906.94 in 1989. The sector is biased towards the domestic market, is reliant on imported inputs, and is capital intensive, using mainly obsolete technology (UNIDO, 1988).

On the other hand, a UNIDO estimate in 1985 showed that 560 large firms in manufacturing (employing more than 100 people) were served by 720 small (formal) firms and 1600 informal sector workshops (UNIDO, 1988). The variance in these estimates is mainly attributable to the definition and measurement of the small enterprise and informal sectors, in addition to difficulties in enumerating small non-formal businesses. Clearly, according to the official statistics as presented in the table above, Kenya's size distribution of industry is biased towards firms employing fewer than fifty people (75%). In other words, that category regarded as the SME sector in Kenya accounts for the greatest proportion of firms in the sector. It must be emphasised here that official estimates of firms in the category employing fewer than 4 people may be significantly underestimated, implying that firms employing fewer than fifty people account for an even larger proportion of the population of firms in manufacturing. At aggregate economy level, the same results emerge. For example, in 1988, firms employing fewer than 50 people accounted for more than 85% of the total firm population, while large scale firms, including government investments, accounted for 14%.

While not desirable, this size distribution has not been accidental. Industrial development and macro- policies have historically favoured large firms providing them with a more favourable business environment than the smaller firms<sup>26</sup>. Consequently, Kenya's industrial activity is dominated by large firms while small firms lag behind them. Large firms contribute an average of 70% of manufacturing value added, and have a higher recorded contribution to GDP than small enterprises. In 1980 for example, this contribution was as high as 93% of manufacturing output. These figures have reduced somewhat (70% in 1990), but are still disproportionate to the size of the sector. *Table 5-3* illustrates the size related contribution to manufacturing value added.

**Table 5-3**      *Share of Manufacturing Value Added (Selected Years)*

Year	Manufacturing Value Added	
	0-49*	50+
1972	17%	83%
1977	12%	88%
1980	7%	93%
1990	30%	70%

\* No. of employees

*Source:* Various Statistical Abstracts - Kenya

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<sup>26</sup>. See Kilby's (1988) contradiction of this contention. He argues that small firms have had preferential support by the government.



Nevertheless, both sources show a picture of a higher representation of large firms to national accounts. There was a sharp increase in contribution of firms employing fewer than 50 people to manufacturing value added between 1980 and 1990. While this study did not test, empirically, the explanations for this sharp increase, it can be argued that the Kenya government's interest in small firms since the ILO report of 1972 which has attempted to include small and micro-enterprises in the national accounts, largely accounts for this increase. However, the possibility of new business development by individuals unable to obtain jobs in the wage sector cannot be discounted.

The higher representation of large firms has had two implications for the small enterprise sector: that since small firms were then concluded not to contribute significantly to national accounts, they were considered less important; and because large firms appeared to contribute more to national accounts, they were considered more important.

In addition, large firms (over fifty employees) have recorded a higher contribution to wage employment. This could be explained by the fact that many of those employed in small firms are recorded as 'Unpaid family labour'. In addition, because the small enterprises sector is not comprehensively recorded, a significant proportion in the sector could be unaccounted for. Table 5-4 indicates the size related contribution to employment in 1990.

**Table 5-4      *Small Enterprises Share of Waged Manufacturing Employment\* (1990)***

<b>Firm Size (No. of Employees)</b>	<b>Share of Employment (1990) (%)</b>
1-4	0.7%
5-9	0.9%
10-19	2.7%
20-49	6.9%
50+	88.8%
<b>Total</b>	<b>100%</b>

\* Although these figures are official government statistics, they underestimate employment in small enterprises, particularly those in the informal sector. A large proportion of SMEs are owner-managed or employ family labour, hence are likely to report a zero-employee status.

**Source:** Statistical Abstract - Kenya

Hence, from the *Table 5-4* above, firms employing less than fifty people account for 12% of total wage employment in Kenya.

Thirdly, large firms have often had very high rates of protection, as high as 312% in some industries, with firms tending towards monopolistic operations, encouraging a high industrial concentration. *Table 5-5* illustrates selected rates of protection in Kenya's manufacturing sector.

**Table 5-5**      *Effective Rates of Protection for Selected Industries (1985-86 figures)*

Industry (or sub-sector)	Effective Rate of Protection
Paper and Paper Products	6%
Beverage and Tobacco Products	38%
Leather and Footwear	80%
Food Products	111%
Textiles and Clothing	126%
Plastics and Pharmaceuticals	129%
Chemicals	211%
Cement and Glass	248%
Iron and Steel	312%
Electrical Products and Transport*	312%

\* The motor vehicle industry falls in this category.

**Note:** Since the Publication of this report, a number of policy measures have been instituted by the Government of Kenya to reduce protection. The country's Sixth Development Plan elaborates these policy measures which include reduction of monopolies and oligopolies. The effectiveness of the measures have not, however, been assessed.

**Source:** World Bank (1987:52).

As a result of such high protection, <sup>27</sup> most industries hold excess capacity as there are no efficiency pressures owing to their monopoly status. Nyong'o (1988), writing on the limits to industrial expansion in Kenya highlights one of the effects of high protection rates:

"Highly protected industries producing high-cost goods for the domestic market and reaping unquestionably high profits under conditions of market monopoly and production inefficiency also tend to be content with preserving what they have and thus to discourage industrial expansion" (p39).

This high protection is one of the explanations of excess capacity in some industries (see earlier discussion). Various explanations for excess capacity in LDCs can be found in the literature, ranging from shortages of raw materials, energy, trained technical and supervisory personnel, and infrastructural problems; and also, where prices for plant and equipment are expected to rise faster than those of other assets, investors accumulate capacity (Phan-Thuy et. al., 1981). The World Bank (1989) reported, for example, that in 1987, the Nominal Protection Rate (NPR) for passenger vehicles in Kenya was 69% while the Effective Protection Rate (EPR) was 173%. These protection rates have been achieved through import restrictions, and other licensing procedures.

At firm level, the motivation for holding excess capacity was found in the argument that the premium paid for holding such capacity was a reasonable consideration for the assurance against resource and market volatility. This has also been attributed to continued uncertainties in the economy, firms continue to hold excess capacity as an anticipatory strategy. For example, constant changes in government regulation concerning foreign exchange, and importation of machines and equipment contributes significantly to anticipatory buying of kits and other raw materials for assembly. Consequently, firms have continued to integrate vertically, and planners are aware of it. For example, as a preamble to presenting the strategy for industrial and commercial development, the *Sixth National Development Plan* (1989) notes:

"With relatively high levels of effective protection in the domestic markets, the commercial and industrial sectors have become progressively inward oriented as many

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<sup>27</sup> One of the main instruments of protection was the Industrial Protection Committee (IPC), one of the key inter-ministerial bodies set up in the sixties as the government's main agency for managing protection issues. In theory, it was the only body responsible for issuing No Objection Certificates (NOC), an import licensing procedure intended to protect domestic industries. In reality, however, the Multinationals have been able to manipulate the political process so as to obtain NOCs for their subsidiaries even in cases where such grants would not be legally and procedurally authorised by IPC. Moreover, the method employed by IPC to enforce protection has also left loopholes to be exploited by the politically influential or well placed individual in firms (Nyong'o, 1988:25). This situation continues to prevail in Kenya.

local firms have been able to reap high profits in the domestic markets while operating at low levels of capacity utilisation."(p141)

In addition, because the existing, mainly large, foreign-owned subsidiaries, saw the strategy of developing SMEs as aimed to supplant foreign capital, the government felt the need to allay such fears. Consequently, the government focused its incentive schemes on the large scale sector. For example, through guarantees on property ownership,<sup>28</sup> and the promulgation of the *Foreign Investment Protection Act* of 1964, the Government not only guaranteed the repatriation of capital and remittance of profits, but also moved to protect the investors from imports. This scenario has continued to temper industrial development in Kenya. While the Kenya Government makes efforts to develop SMEs, large foreign firms continue to dominate the economy.

The dominance of large firms has other implications for Kenya's development. Talking about large firms in Kenya is synonymous with talking about foreign firms, particularly subsidiaries of MNCs. Because they tend to have a high level of foreign capital invested, large foreign owned firms have therefore caused concern about capital flight through transfer pricing and other activities. This raises the sensitive question of who owns industry in Kenya. As a result, any strategies which seek to reduce foreign ownership of industry in Kenya are suspect.

## 5.4 SMALL ENTERPRISE DEVELOPMENT IN KENYA

### 5.4.1 THE RATIONALE FOR SME DEVELOPMENT IN KENYA

One of the strategies adopted for Africanisation was to encourage and promote small enterprise ownership by indigenous African-Kenyans. As noted above, since independence from colonial rule, Kenya's primary objective has been to Africanise the economy (GOK: 1965), using both interventionist<sup>29</sup> and non-interventionist approaches. In the early sixties, the favoured strategy was direct Government investment in the private sector through parastatals in addition to an employment policy which favoured indigenous Kenyans to expatriates, allowing Kenyans to join the management ranks from which they had been excluded during the colonial period. At the same time, a few Kenyans joined the business classes (Nyong'o, 1988). By 1972, however, there was still an under-representation of Kenyans in business (ILO, 1972).

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<sup>28</sup>. This was contained in *Section 75 of the Constitution of Kenya*.

<sup>29</sup>. Such specific measures as the Trade Licensing Act of 1967; the Transport Licensing Regulations of 1967; the Immigration Act of 1967; the Exchange Control Notices No. 19 and 36 of 1971 were taken to control the nature of ownership by foreign investors.

The 1972 ILO Mission to Kenya highlighted the potential of the informal sector as a source of new jobs, and vehicle for technological innovation and rapid acquisition of business management skills. Since then, in virtually all of Kenya's development plans and other policy documents, the small enterprise sector has been viewed by planners as an important mechanism for indigenisation of the economy; as well as a vehicle for import substitution; as a mechanism for rural-urban balance (GOK 1965; 1974; 1979; 1986; 1989); and more recently, as an important vehicle for export promotion (GOK 1992). In 1989, together with United Nations Development Programme (UNDP) and the International Labour Organisation (ILO), the Kenya Government launched its first policy paper outlining its intended strategy towards the development of the small enterprise sector. In outlining its broad programme of support for SMEs, the government argued in the *Sessional Paper No. of 1986* that

"For Kenyans to enjoy even modest improvements in their current standard of living, it will be imperative that ..... the great majority of jobs be created, not in the cities or in large industry, but on farms and in small scale industries and services, both rural and urban.(p2)"

This policy paper has since been refined and given specific dimensions in the *Sessional Paper No. 2 of 1992* (GOK, 1992) specifically addressing the development of the sector.

Hence, based on the recommendations of this ILO mission, and based on the concern about ownership of industry, small enterprise development was seen as a platform for Africanisation. Vaitos (1991) concludes that two reasons motivated the government choice of strategy: government doubts about the commitment of TNCs to technological development; and the potential of transfer pricing. To elaborate he notes,

1. "Since large-scale manufacturing and services are so dominated by TNCs, ..... underdevelopment of national technological and productive capabilities and the severely limited availability of specific critical resources call for, and indeed, promote collaboration with foreign enterprises. Yet, the objectives and central planning of TNCs do not always promote national development policies used for Africanisation, ... with critical implications on the country's relations with foreign investors." (p19)
2. "The TNC's internal organisation and the absence of competitive market forces in inter-affiliate transactions offer TNCs much freedom and flexibility to shift resources across national boundaries. The government needs counter measures so as to get an equitable share of income generated." (p19)

Implicitly, therefore, the indigenous small enterprises were supposed to counter the dominance of large-scale enterprises, and stem some of the negative consequences of such dominance. The



tensions that have ensued are to be expected, particularly as the long-term objective by indigenous Kenyans was "to supplant foreign capital [in Kenya] (Kaplinsky, 1982:193). Since the *Sessional Paper No. 1 of 1986*,<sup>30</sup> the Kenya government's blueprint for the management of the economy for renewed growth put in motion a specific small enterprise development strategy as a panacea for the country's development aspirations (GOK, 1986; 1989; 1992), particularly to indigenise industry.

#### 5.4.2 KENYA'S APPROACH TO SME DEVELOPMENT

Like many developing countries faced with the realities of poor economic performance, and spurred on by the successes of formerly developing countries in Asia (known as Newly Industrialised Countries - NICs), Kenya saw small enterprises as a vehicle for developing an indigenous entrepreneurial capacity. Initially arguing that indigenous entrepreneurs were limited by a lack of resources, particularly finance and managerial training, the initial programmes and strategies aimed to remove or reduce these limitations. The policy measures and programmes which have been developed specifically to guide the development of the sector, range from developing assistance institutions which support small enterprises, those which initiate institutional and regulatory reforms to assist the small enterprises sector, and those seeking to directly offer support to small enterprises.

These strategies were formulated to promote entrepreneurship by focusing on small enterprises, arguing that small businesses were predominately set up by indigenous Kenyans, and could constitute the basis for developing an African business class in Kenya (Marris and Somerset, 1971). Little was done to find 'real' entrepreneurs in the economy, hence all small business owners were considered potential candidates for the various assistance programmes such as finance, training and marketing, which specifically targeted small business owners. Since the sixties, for example, in addition to various special programmes in the commercial banks, various development banks have been set up to finance indigenous 'entrepreneurs': the Kenya Industrial Estates (KIE); Development Finance Corporation of Kenya (DFCK); Kenya Commercial Finance Corporation (KCFC); Small Enterprise Finance Company (SEFCO); Industrial Development Bank IDB); and the Joint Loan Board Scheme (JLBS). The *Exchange Control Notices 19 and 36 of 1971* reinforced this strategy by regulating the foreign company's access to local capital,

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<sup>30</sup>. This paper remains Kenya's key statement for national development for the period 1986-2000. The key features of the paper include: strengthening rural-urban linkages, encouragement of small and informal enterprises as a source of "fast economic growth", acceleration of indigenisation of the economy, and the promotion of exports through both small and large enterprise promotion. The subsequent *National Development Plan of 1989-1993* provides the specific policy framework for achieving the stated objectives of this blueprint for national development.

particularly short-term loans, thus freeing large proportions of local capital to be used by local 'entrepreneurs'. In addition, the Kenya Industrial and Business Training Institute was set up specifically to train indigenous business owners and their staff. To a large extent, these have continued to be the bases for the small and medium enterprise development programmes initiated and supported by the government. Various researchers note, however, that political and managerial problems have, however, prevented many of these programmes from producing the stock of indigenous entrepreneurs anticipated by the government (Coughlin, 1988c; Ikiara, 1991). Rigidities in the institutions meant to encourage indigenous Kenyans to enter into industry and commerce have been counterproductive (GOK, 1986). Instead, an informal sector has continued to grow as small business owners found themselves 'pushed' onto the 'black' market due to a prohibitive regulatory and enforcement environment. Large enterprises have also erected entry barriers in many industries, mainly through accumulation of proprietary technology, and scale.

In addition to this set of promotional strategies, African businesses were given preference in particular areas of business through the *Trade Licensing Act of 1967*. The same act also established the parastatal, Kenya National Trading Corporation (KNTC) which was to affect directly the activities of foreign owned commercial firms. The *Transport Licensing Regulations of 1967* restricted domestic transportation to Kenyan owned firms, even in the lucrative oil and oil products transportation business. The *Immigration Act of 1967* and the establishment of the Kenyanisation Bureau regulated employment of non-citizens through work permits, forcing foreign firms to 'train' Kenyans in industrial jobs.

The conclusion arrived at by the *Sessional Paper No. 1 of 1986* provided the political basis for a change of emphasis in the promotion of micro- small and medium enterprises in Kenya. In programmatic terms, the most noticeable change of focus has been the development of a coherent strategy for small enterprise development, articulated in the *Sessional Paper No. 2 of 1992*. A second change in approach has been the increasing shift to private sector participation in implementing assistance programmes to the sector, with the government playing what is popularly referred to as a 'facilitative role'. This means that instead of direct involvement in programme delivery, the government is to focus on providing an enabling environment (World Bank, 1989) through macro-economic policies, fiscal strategies, and the provision of a skilled labour resource through education and training, and technological dissemination. The effects of this new approach have not been yet been evaluated.

### 5.4.3 THE NATURE AND CONTRIBUTION OF KENYA'S SME SECTOR

There is considerable ambiguity in the definition of the SME sector.<sup>31</sup> Almost all surveys carried out in Kenya have adopted a different definition. However, over time, the SME sector has come to be regarded as including all those businesses employing fewer than 50 people, and within it three distinct categories as shown in *Table 5-6* below.

*Table 5-6 SME Classification and Distribution*

Type	No. of Employees	Share of SME Sector*
Micro-enterprises (formerly known as the 'informal sector')	0-10	88.9%
Formal Small Enterprises	11-20	9.8%
Medium Enterprises	21-50	1.3%
<b>Total</b>	0-50	100%

\* These figures are provisional results of a study conducted by the GEMINI project funded by United States aid agency (USAID), in Kenya. The same study also estimates that of the estimated enterprise population of 912,161, about 76.4% are located in the rural areas, while 24.6% can be found in the urban areas.

**Note:** A UNIDO (1986) study gives a slightly different picture, basing its analysis on share of employment. It stated that the category under 20 employees represented 41.62% while the category employing 21-50 employees represented 58.38%.

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<sup>31</sup>. In Kenya, the official definition of large firms refers to firms employing more than 100 people. In practice, however, firms employing fifty people is often included in this category depending on levels of capitalisation. The literature on the measurement of firm size using employee numbers is controversial. It is argued that this is particularly important in cases where job creation crises have restricted the levels of capitalisation of large firms, necessitating the use of labour intensive technologies. Consequently, questions about the comparability of firm behaviour based on size and output arise.

The debate about firm size is far from concluded in Kenya as elsewhere. Those working in the informal sector with micro-enterprises include those businesses employing up to ten people, yet the prevailing official definition is an employee number of up to five people. Micro-enterprises are regarded as those enterprises employing 0-5 people while small enterprises are those employing 6-49 people and medium firms are those employing 50-99 people. Additionally, controversy still surrounds the use of employee numbers to classify businesses in Kenya due to the effects of high capitalisation in some industries, while other use labour intensive processes.

The SME sector (firms employing fewer than 50 people) is generally underrepresented in manufacturing. Even while noting the inadequacies of data on small and medium enterprises, *Table 5-3* indicates that formal firms with fewer than fifty employees (the SME sector) contributed 17% of manufacturing value-added in 1972, dropping to 7% in 1980, and then rising slightly to 19% in 1990. In 1990, this category of firms contributed a meagre 12% to manufacturing employment (see *Table 5-4*). In addition, the small and medium enterprise sector's inherent weaknesses have contributed to their marginalisation. They have neither increased nor grown at the expected rate despite government and donor support for the sector (Coughlin, 1991a).

Few analyses exist of the sector's performance indicating its success or shortcomings, or those of the strategies adopted for their development. Although there are some indications of growth these are minimal, and could be explained by factors other than an increase in the contribution of the sector to the economy. For example, since the Government's interest in the SME sector as a vehicle of development (GOK, 1986), firms which were formerly in the 'informal' sector, have been progressively 'formalised', thus being gradually included in national accounts. Several studies have attempted to quantify the sector and its activities.<sup>32</sup> The GEMINI (1993) study implies that there are more small enterprises than previously estimated by the Central Bureau of Statistics (1988) study (350,000), employing more than 2 million people. Official data show an increase in urban informal sector employment from 41,000 in 1973 to 202,000 in 1987, while jobs in modern establishments increased by two thirds in the same period (Ikiara, 1991:314).

However, various reports, particularly those issuing out of World Bank studies, imply that one of the most serious handicaps of Kenya's industrialisation is the absence of the middle level enterprises employing fifty to one hundred people - 'the missing middle'. This concept is important for this thesis because it is, perhaps, this category of firms that have the managerial and technological capacity to provide the needs of large firms in Kenya. The GEMINI report suggests that medium sized enterprises play a small role in the economy, and none at all in the rural economies. It also notes that small, formal enterprises contribute 1.4% to national enterprise population, while the micro-enterprises make up the bulk of the enterprise this population. Consequently, large firms may have a point when they claim that there is a serious paucity of adequately developed small firms who are able to meet their needs. This position is supported by

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<sup>32</sup> For example the Central Bureau of Statistics survey (Kenya) on micro enterprises (CBS, 1988) reports that the informal sector accounts for 20% of total recorded employment and generates 22.7% of total urban employment; a report, *Improving the Growth Potential of the Small Scale and Informal Sectors*, by J Tomecko and C. Aleke-Dondo for the World Bank's Country Economic Memorandum on Kenya (1993). Another example is the ongoing census of the USAID sponsored GEMINI project, whose results have not yet been published



the World Bank report (1987) although the magnitudes of enterprise populations differ. An important additional point made by the World Bank report is that even those existent medium-sized enterprises are concentrated in sub-sectors such as food processing, saw milling, furniture production, printing and sheet metal fabrication. Few enterprises operate in non-traditional sub-sectors such as vehicle parts and components sub-sectors.

The traditionally cited reasons for this small contribution has been the negative policy and institutional frameworks within which small firms work, and an alleged unequitable support of the large scale sector. These contentions have been disputed. The World Bank (1987) report notes that

"despite channelling US\$50 million in this sub-sector by various development banks, (Kenya Industrial Estates - KIE, Kenya Commercial Finance Corporation - KCFC, Small Enterprise Finance Corporation - SEFCO, Industrial Development Bank - IDB), there has been a net addition of only 100 firms in a decade" (p210)

The type of enterprises included in this evaluation are the small to medium sized firms generally supported by the financing programmes listed. While this is only a small section of the sector employing less than 100 people, it is a reasonable representation of formal, modern firms which concern this study.

Using KIE clients in a similar way to represent the formal small and medium scale sectors, Kilby (1987) also concludes that

"For the larger, non-traditional ventures - until recently the prime target - KIE's [Kenya Industrial Estates] efforts have been remarkably unsuccessful" (p69).

Kilby adds that few micro-enterprises ever "graduate" to become medium sized firms (Kilby, 1987:37). He suggests that the "still developing entrepreneurial capacities" are "the principal explanation for the sector's lacklustre record" (p47), despite the assistance to this category of firms (discounting arguments that the sector has not had support in all of the areas he examined). This contention is echoed by the World Bank report (1987) which notes "clearly, Kenya's small-scale industry has been seriously hampered by weak entrepreneurial performance rather than because of a lack of government support or of relatively hostile policies" (p244).

Other weaknesses of the sector relate to the entrepreneurial capacity of indigenous Kenyans. Even while advocating the development of Small Scale Enterprises (SSE) as a strategy for the indigenisation and revitalisation of the economy, Kenyan planners concede the inadequate knowledge and skills of those who are to take on this task. For example in the *Sixth National*



*Development Plan - 1989-1993*, it is noted that while the government is committed to the development of small enterprises and the indigenisation of the economy,

"..... [it] is fully aware that serious constraints lie ahead since those endowed with suitable skills and management abilities often lack the opportunity of appropriate exposure, which hinders their success in business." (p223)

Clearly, on its own, the SME sector in Kenya is significantly weak. Recognising this problem, the Government undertook, *inter alia*, to "encourage partnership between Kenyan and non-Kenyan entrepreneurs" (GOK, 1989:224) for the transfer of management and technical skills, hoping that this strategy would foster faster industrial development and encourage the diffusion of technology in the country through joint venturing and sub-contracting relationships with foreign firms. The Sessional Paper no. 2 of 1992 on the *Jua Kali*<sup>33</sup> sector, reiterates the need for the local indigenous businesses to interact with the larger businesses as one way of achieving faster entrepreneurial and technological capabilities within the economy. However, in view of the role assigned to the small enterprise sector, and the perception of 'displacement' by large firms, this could prove problematic. It is within this context that the study was conceived - the search for a strategy which would promote small scale enterprises within the framework of the existing dominance of large firms, without perpetuating existing tensions between large and small firms. This study postulates that one of the reasons why small enterprises have not grown at the expected rate is this large firm dominance and control of the social, political and institutional structures which govern the management of the economy.

## 5.5 LARGE AND SMALL FIRM LINKAGES IN KENYA

Although there may be some inter-firm linkages, particularly sub-contracting and joint ventures in Kenyan industry, little has been documented about their nature or those factors influencing their existence. In addition, little evidence exists to show that the government encourages the use of local products as a basis for inter-firm linkages within industrial sectors. Various researchers such as Murage (1983), Coughlin (1988b) and Masai (1991) anecdotally note, however, their limited use, highlighting the various impediments to outsourcing from local firms. The large MNCs and other firms have also found little impulse to use local materials and suppliers (Coughlin, 1991a;

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<sup>33</sup>. This is the catch-all phrase used to describe the informal, micro-enterprise, and small scale enterprise sectors in Kenya. The literal meaning of the term is *hot sun*, adopted as a way of describing the conditions under which the informal sector operators work. It was adopted, principally, to address the negative image and impact of the term "informal sector". Initially, the term *Jua Kali* was used to describe those 'artisans' engaged in the industrial sector only. Currently, this term is used to refer to all operators including those in the trade and services sector.

Gershenberg, 1983). Gershenberg (1983) in his study on MNCs subsidiaries in Kenya reported that "in no case did we find firms undertaking to assist in the development of local suppliers" (p23), and concluded that

"the government of Kenya does little to actively encourage the use of local resources in production and thus to maximise local value added in [the] manufacturing/ processing sector" (p23).

Consequently, prior to 1991 when the Kenya Subcontracting and Partnership Exchange (KSPX) was established, there was little evidence of a political interest in encouraging large-small firm linkages in Kenya. No strategies existed which deliberately developed linkages between large and small firms in industry as a strategy for exploiting the advantages of a size related division of labour in industry and to increase the contribution of small firms.

The KSPX was set up by the Kenya government with the help of United Nations Development Programme (UNDP) to bring together large, medium and small enterprises in a formal exchange (UNDP/GOK Project Document, 1990), and to build a data bank as a facility for these activities. The exchange is still in its infancy with many of its problems arising from the traditional lack of trust between large and small firms in Kenya. It is expected that its linkage with the various membership organisations assisting business people, for instance the Federation of Kenyan Employers (FKE), will ameliorate this situation. However, there are serious doubts in the business circles about its survival, particularly emanating from the effect of government management of the programme. At a time when public sector initiatives are viewed negatively, even with some suspicion, the private sector is less likely to use the exchange and its facilities.

Having said that, the exchange has already embarked on a programme to develop a data base of contractors and potential sub-contractors. In order to focus its initial programme, the vehicle assembly industry and related sub-sectors such as the auto-ancillary, metal fabrication sub-sectors, have been surveyed and documented. This study's interest in the vehicle assembly sector was reinforced by the government's recognition of its potential for external sourcing and sub-contracting activities, based on the successful experiences of this sector in industrial development elsewhere (GOK, 1986). Together with a specific rationalisation strategy aimed at streamlining the vehicle industry and encouraging local procurement of components, this strategy was expected to develop a local capacity to supply the vehicle assembly, and other industries.

## **5.6 THE KENYAN MOTOR VEHICLE INDUSTRY**

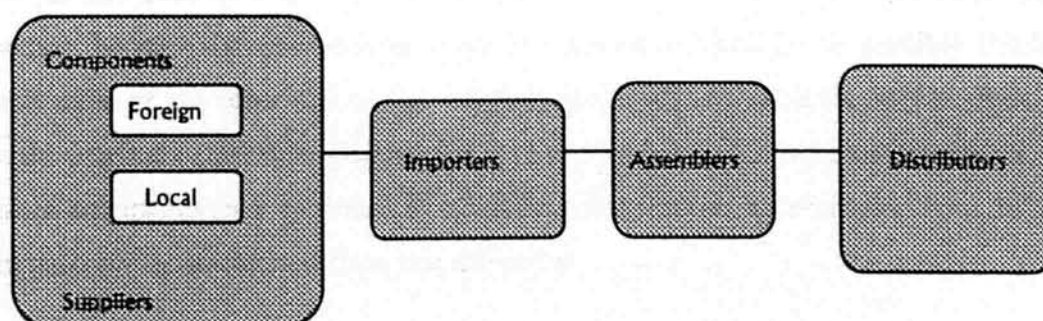
This section briefly outlines the structure of the Kenyan motor vehicle industry. Although small, and despite its basic role in provision of transportation, its impact on the rest of the economy

through linkages with the auto-ancillary, metal fabrication and repair sub-sectors makes it an important focus for Kenyan industrialisation. It directly employs an estimated 15,000 people, and another 15,000-20,000 people in related repair and service industries (KMI, 1990). In addition, policy makers believe that this sector is likely to form the basis of a machine tool industry (GOK, 1989). However, its importance to small enterprise development should be viewed from the framework of the rationalisation and localisation programmes.

### 5.6.1 STRUCTURE AND OPERATIONS OF KENYA'S VEHICLE VEHICLE ASSEMBLY INDUSTRY

Since the establishment of the Kenyan Vehicle Industry (MVI) in the 1950s, with servicing as the main activity, the sub-sector has grown to include auto ancillary services, vehicle body building, and coach works. Basing its decision to license vehicle assembly in Kenya on existing auto-ancillary activities and maintenance services, the government began to develop, deliberately, the assembly of vehicles by requiring assemblers to shift from semi-knocked-down (SKD) to completely-knocked-down (CKD) levels of assembly (GOK, 1974:292; 1979:371; 1983:204). Low demand for vehicles on the domestic market, and the absence of a long term strategy to foster transition from assembly to manufacture, have limited the growth of the sector and its ancillary sub-sectors. As noted in the discussion above, the sector is currently characterised by a proliferation of makes and models, and yet no official policies defining the designs and models to be used in the country exist.

The vehicle assembly industry in Kenya consists of four distinct categories of participants presented in *fig 5-1* below. This industrial structure has been summarised according to current relationships between the various components of the sector.



**Fig.5-1 Components of the Kenyan Motor Industry (Source: Field Notes 1992/1993)**

The first category consists of the three assemblers: Kenya Vehicle Manufacturers (KVM), Associated Vehicle Assemblers (AVA), and General Motors Kenya (GMK). The former two plants are contract assemblers<sup>34</sup> while GMK is a franchise holder as well as assembler, hence, it is the only non-contract assembler. Until the launch of the privatisation programme aimed to reduce public investments in industry, the government held at least 25% equity in each of the assembly establishments. At the time of publishing this report, the privatisation process was not yet complete. Other shareholders include the major franchise holders (explained below) in Kenya as will be discussed in the findings in chapter seven.

The second category consists of thirteen franchise holders (see list in Appendix A6)<sup>35</sup> better known in Kenya as 'importers' of Completely Knocked Down kits (CKDs). They hold licences to import, assemble and market on behalf of principal vehicle manufacturers in Japan, Italy, UK, Germany, America, etc. About half of these have some shareholding interests in at least one of the assembly plants or are associated with companies which hold shares in these assembly plants. This category is generally thought of as the power base of the sector, owing to its central position in the decision-making process regarding what makes and models are to be marketed in Kenya. However, because of their commercial orientation, their decisions have been variously argued to conflict with Kenya's industrialisation goals.<sup>36</sup>

The third category is often subsumed in the second category because of the thin dividing line, if any, between them. This category consists of the distributors who are usually also franchise holders/importers. However, there are distributors who are merely serve as outlets for major franchise holders. The fourth category is the auto ancillary sector comprising a variety of independent small and medium enterprises who supply the industry with assembly and replacement parts. Masai's study (1991) reported that these numbered 30 small and medium-sized firms in the auto-ancillary sub-sector, and 15 coach works and body-building enterprises. However, because the importers purchase as complete a CKD kit as possible (Masai, 1991), or import most of the other inputs, this category has tended to serve the replacement market more than the original equipment (OE) market. Yet, it is in this category that prospects for a wide range of small enterprises may be found. In industrialised countries, for example, about 50% of the value of an automobile are derived from this sub-sector.

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<sup>34</sup>. The two contract assemblers (KVM and AVA) only assemble on behalf of the franchise holders. This implies that they do not import their own CKDs for assembly in their plants.

<sup>35</sup>. This includes GMK who import for their own assembly needs.

<sup>36</sup>. Kenya Motor Industry Association provide anecdotal evidence of tensions between assemblers and importers, arising mainly from this power structure within the industry.



An important sector not included in this research is the service and repair sector of the motor vehicle industry, including the body fabrication and repair sub-sector, which constitutes a fifth category of the industry. Although vital for the industry's activities, it is not directly linked into the assembly or auto ancillary sectors and has not, therefore, been included in this study. Besides, many of the operators are micro-enterprises, or unregistered self-employed mechanics and the magnitude of its contribution has not yet been documented. In addition, what is considered as the repair service sector in Kenya includes all types of mechanics such as watch and electrical appliances repairers. Consequently, the quantification of the sector or its activities is problematic. However, suffice is to say that in Kenya, this latter category employs perhaps the largest number of the small enterprise workers in the vehicle assembly industry.

### 5.6.2 PRODUCTION ORGANISATION IN KENYA'S VEHICLE ASSEMBLY INDUSTRY

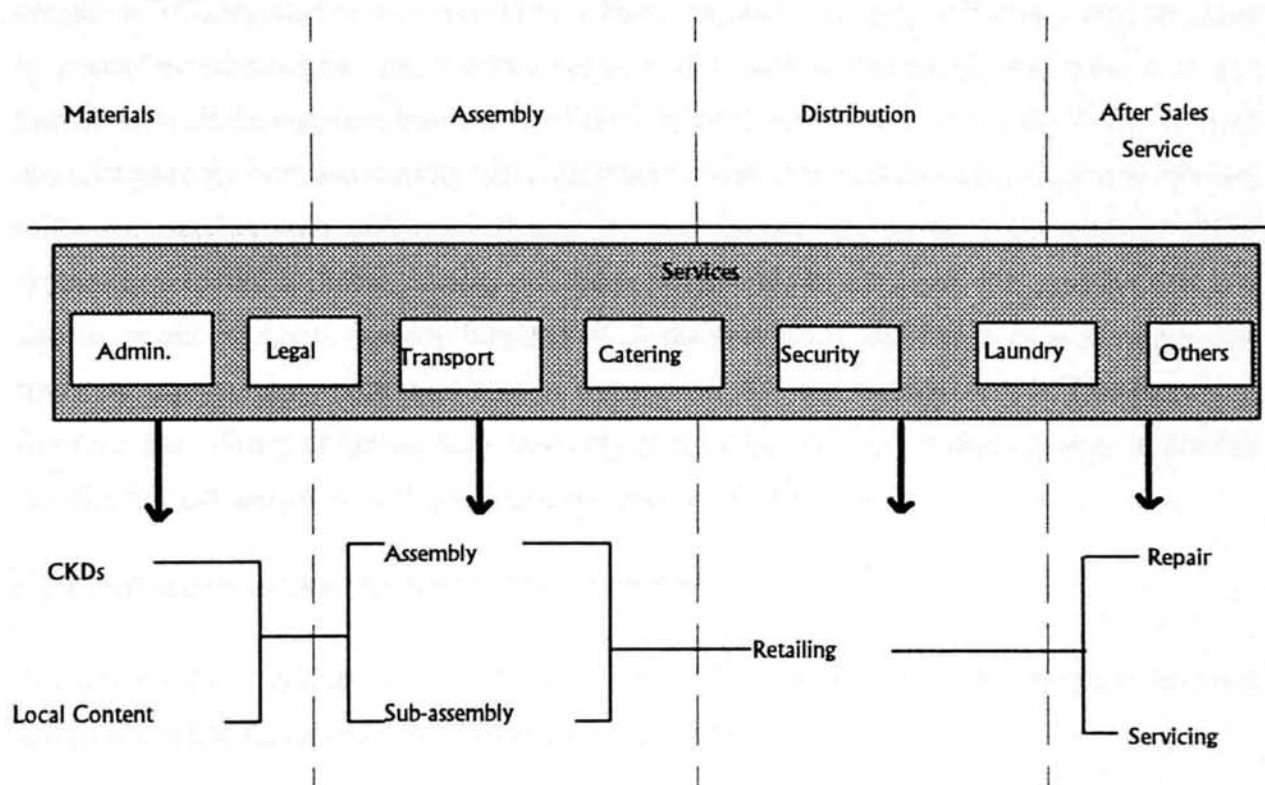
Viewed in terms of production organisation, the general 'layout' of the sector is reflected in the following activity flow diagram *Fig 5-2*. This analysis of industry-wide production organisation is important in informing the study regarding the ability of firms in the industry to de-couple their production to allow for fragmentation and/or outsourcing from other firms. Intuitively, there is greater potential for de-integration where production organisation within the industry allows dis-aggregation or de-coupling to take place. From the diagrammatic representation of the activities of the industry presented in *fig. 5-2*, it is clear that productive organisation in the vehicle assembly industry is generally dis-aggregated, and can be said to have the potential for de-coupling of production activities. For example, material inputs procurement is a 'separate' process from assembly, distribution and after-sales service. In addition, the service inputs are separate functions introduced into the production chain at different stages. Effectively, therefore, the four 'production chain' components (*viz.* materials procurement, assembly, distribution, and after-sales service) can be organised internally by one firm, or externally by several firms. At the same time, in many manufacturing firms, services can be provided by outside suppliers.

Consequently, based on *fig 5-2*, it can be argued that the motor assembly industry in Kenya, like other motor industries, has the potential for de-coupling.

### 5.6.3 CAPACITY UTILISATION IN THE MOTOR VEHICLE INDUSTRY

As was shown in the first section of this chapter, it is generally argued in Kenya that large firms suffer from low capacity utilisation. While the motor vehicle industry is no exception, its capacity utilisation levels have been relatively higher on individual plant basis. In 1990, actual capacity in the industry was utilised in the following proportions:





**Fig.5-2 Activity Flows in Kenya's Motor Industry**

Source: Field Notes and Observation 1992/1993

Notes: 'Others' includes insurance, information (computer) and miscellaneous services

**Table 5-7 Capacity Utilisation Levels for all Assemblers**

Assembler	Capacity utilisation
AVA	80%
GMK	63%
KVM	74%

**Note:** The capacity utilisation rates are estimated on a one shift basis

**Source:** Field Notes 1992/1993

Evidently, plant capacity utilisation in the sector is significantly higher than the manufacturing average of 34% reported by Coughlin (1985). However, due to industry difficulties brought about by general world recession, and political and economic instability in Kenya, this reduced to less than 30% for all the suppliers between 1990-1993. In 1992, for example, AVA was forced to close down its plant for over two months, while the other two assemblers reduced production to half-day shifts, interspersed with prolonged closure for maintenance and holidays (Interviews). Other explanations for the declining capacity utilisation levels could be advanced. It is probable that it is also the result of excess capacity installations in the first place, and that current utilisation are structural adjustments within the sector in response to the 'true' demand levels. This questions, therefore, the efficacy of having three assembly plants, each with an installed capacity to provide vehicles for both prevailing and anticipated demand levels in Kenya.

#### 5.6.4 PROBLEMS IN THE MOTOR VEHICLE INDUSTRY

The motor vehicle industry has been fraught with problems since its inception, the most recurrent being. According to managers and observers in the sector:

1. Low levels of foreign exchange available for the procurement of CKD kits. As a result, the assembly plants have never produced at full capacity. They have always operated on a one shift basis, and even then, have never achieved the potential of installed capacity.
2. Lack of standards to control the quality of local components and parts. Managers in the sector reported that consequently, it has been difficult to achieve high quality standards for these components, particularly as it has also proved difficult to standardise various parts and components. On the other hand, this lack of standards constitutes, perhaps, the most deleterious loophole in the local sourcing programme. In the absence of standards, buyers have been able to claim that supplier's products are of low quality, and therefore request permission to source abroad.
3. Continuous influx of imported vehicles onto a small<sup>37</sup> and fragmented<sup>38</sup> market. This has not only reduced the new vehicle market drastically, but has also

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<sup>37</sup>. In 1990, for example, the new vehicle registration was 18,000 vehicles (excluding agricultural equipment) and just over 16,900 vehicles in 1991. The locally assembled component of these figures has declined considerably in the last few years. In 1990, for example, 13,580 vehicles were locally assembled, while in 1991, just over 9,460 vehicles were assembled.

contributes to the proliferation of makes and models, which in turn prevents specialisation in the auto-ancillary sub-sector.

4. Relatively higher prices of locally assembled vehicles, as compared to imported equivalents, brought about by high taxation, high duty, dealers' mark-ups, and the high cost of local components, in addition to the higher production costs emanating from lack of efficiency which is caused, in turn, by a proliferation of makes and models;

This latter contention has been the basis of the Kenya Motor vehicle industry Association (KMI) lobby to reduce the number of makes and models in order to allow the assembly industry to develop sufficient experience to sustain efficient production activities. In 1987, the government agreed to begin the rationalisation process, and reiterated this in its *Sixth National Development Plan* in 1989. In practice, rationalisation has been neither seriously implemented nor effectively policed by the government. A position paper prepared by KMI in March of 1990 titled "Passenger Car Rationalisation: Facts and Forecasts" is an indicator that by this time, the industry was still swamped with makes and models. In newspaper editorials<sup>39</sup> in 1993, business correspondents reflecting prevailing opinion by observers and practitioners in the industry have continued to decry the proliferation of makes and models, and the increasing number of "cheap second-hand imports".

#### 5.6.5 RATIONALISATION OF THE MOTOR VEHICLE INDUSTRY

Rationalisation of the motor vehicle industry is seen by policy makers in Kenya as one approach to localisation of industry, particularly in the related parts and components industries. Consequently, the prospects for linkages between large and small firms have been conceptualised on the basis of rationalisation and localisation of sourcing in the motor vehicle industry. Kenyan literature such as Murage (1983), Coughlin (1988c) and Masai (1991) argue that because of the proliferation of makes and models of vehicles, it is difficult to gain experience in the production of various parts and components destined for the motor vehicle industry. There are currently not fewer than 40 different makes of vehicles imported into Kenya as new, used or reconditioned vehicles. Typically, each make offers an average of 12 major variants, doubled every five to 10 years. Hence of the 3000 vehicle models available world-wide, Kenya imports up to 300 of these and assembles about

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<sup>38</sup>. It has been noted that Kenya assembles at least 30 of the 3000 makes and models manufactured world-wide, for a market of only 10,000 new vehicles annually.

<sup>39</sup>. For example, the *Sunday Nation - Life Style*, August 22, 1993.

30 (KMI, 1990). This is a high level relative to the new<sup>40</sup> vehicle demand of about 10,000 vehicles annually. This market has continued to decline in the face of world recession and other economic difficulties in Kenya brought about by, among other reasons, political instability. *Table 5-8* below indicates the decline in new vehicle sales since 1986. It is these small markets that have led to the lobby for rationalisation of the industry.

It is important to note, at this juncture, that the importance of economies of scale in the motor industry in general (>250K pa for the auto-assembly, and > 400K pa in engine manufacture) puts to question the logic of promoting a vehicle assembly industry in Kenya. It also questions the potential for backward linkages in this industry. Noting these arguments, and in the absence of field data, it can only be conjectured that Kenya promotes the motor-assembly industry for 'strategic' reasons. Consequently, for those involved in the auto-assembly industry in Kenya, scale economies appear to be unimportant. In turn, this questions the importance of scale economies in industries which have traditionally found it important to operate at certain minimum output levels, such as the car industry.

*Table 5-8      Changes in Vehicle Sales (Locally assembled vehicles excluding agricultural equipment)*

Year	Units	Variation over previous year (%)
1986	10,757	-1.36%
1987	13,625	-26.66%
1988	12,837	-5.78%
1989	14,176	+10.42%
1990	13,582	-4.19%
1991	9,458	-43.6%
1992	8,372	-11.48%

*Source:* Kenya Motor vehicle industry Association (KMI) statistics

The KMI argument for rationalisation is based on economies of scale, emphasising the effects of proliferation on transaction frequency and the difficulty in accumulating organisational experience.

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<sup>40</sup>. This is the demand for *new vehicles* as opposed to the general case. The major constraint to the demand for new vehicles in Kenya is cost. Consequently, cheaper comparable imported vehicles dominate the vehicle market. When considered at an aggregate level, the average annual demand for vehicles in Kenya is 22,000 units.

As noted above, these are exacerbated by market fragmentation. Every distinct model requires approximately 1,000 component spare parts to ensure full availability. Minor variants of these models involve about 100 components and spare parts, while major variants require 500. Thus for every additional major model variant, an additional stock of 500 different component parts must be held to ensure one piece of spare part is available. If, for example, 10 pieces of each part for 300 different variants are required, stocks of 1.5million line items must be held to service the demand (KMI, 1990). According to the KMI estimates, it would be beneficial to Kenyan industry if these components were sourced locally, but currently, less than 20% on average are locally sourced (this includes parts and components procured as spares). Even in such cases, this figure is reduced significantly by the high level of imported inputs used in the sector. In any case, in order to build expertise, the types would need to be reduced significantly.

As a result of proliferation, it has been difficult for suppliers to develop the requisite experience needed for quality improvement. The two factors discussed in the preceding paragraph, therefore, provide a reasonable basis for the rationalisation of the motor vehicle industry. This aim was incorporated into the operational structure developed by the government to direct the activities of the sector from inception.

In its Supplemental Agreement with the assemblers (pp 3-4), for example, the aims and conditions of instituting CKD conditions was to:

1. rationalise the assembly industry;
2. increase the degree of breakdown in the imported CKD kits;
3. increase the number and types of vehicle components manufactured locally;
4. provide training for new skills and technical expertise;
5. provide increased employment opportunities in assembly plants and local component-producing industries;
6. encourage overseas manufacturers of vehicle components to establish local partnerships with Kenyan companies or to licence Kenyan companies to manufacture their components;
7. encourage further use of local raw materials;
8. bring down prices of vehicles in the country .



Although no empirical evidence exists informing the extent to which these goals and objectives have been achieved, casual observation of the activities of the sector show that to date, little rationalisation in the motor vehicle industry has been achieved. One of the reasons for the failure of the rationalisation programme<sup>41</sup> is the lack of support from various parties involved in the sector, particularly the reluctance of the assemblers and importers to source locally. At the inception of assembly activities in Kenya, the government agreed with the assemblers to achieve local content levels of 40%-50% by 1982. In Masai's study (1986) assemblers stated local content achievement of 40%, but his own assessment was that in reality, when tax and labour deductions are taken into account, the effective local content levels average about 25%. In the same study, the assemblers attributed this low performance to a lack of government commitment to implementation of policies which restrict imports of completely built units (CBU), rationalisation of makes and models available on the market, and assistance in the development of local suppliers (Masai, 1986). The high cost of local components, affected by low levels of demand, also renders local procurement much more expensive. In Masai's study, assemblers found little incentive to source locally many of these components. The importer category is, on the other hand, motivated by short-term profits. They therefore do not see incentives in the current industry environment - the combined effect of deletion costs, unavailability of good quality components, and the relatively higher investment involved in local sourcing.<sup>42</sup> Thus, for local small manufacturers to benefit from this strategy, the government has to focus on removing the policy impediments which prevent the local assemblers from using local components and services. The first step is to rationalise the motor vehicle industry in addition to providing institutional support to auto-ancillary firms in the sub-sector in order to make then 'attractive' to large buyers.

KMI, the industry's lobby group, has made efforts to press the Government to take steps to control the influx of makes and models onto the market, particularly those entering the country through 'unconventional' import channels. In a position paper produced in March, 1990 to argue for rationalisation of passenger vehicles (and in principal, commercial vehicles as well), KMI (1990) argue that for various reasons, only 40 models are appropriate for the Kenyan markets at any one time. The report argues that

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<sup>41</sup>. See the various appendices for the contents of the Legal Notices.

<sup>42</sup>. In arguing for rationalisation of the Kenya motor vehicle assembly industry, the Kenya Motor Industry Association give six investment related problems impeding local assembly and sourcing: the manufacture of expensive jigs for frequently changing models; dedication of an assembly line and training for new makes and models; kit pack logistics and low deletion allowances; development of local specifications for the full range of models; investment in spares stocks; and special training for service workshops.

"This level gives adequate choice and reasonable economies of scale. It is also the number that will naturally evolve through local assembly. More models would be uneconomic. Fewer models would require artificial restrictions with political, commercial and technical penalties." (p1)

Summarising their argument for rationalisation, KMI present the main benefits as

1. maximum growth of local industry, jobs and skills by multiplying vehicle volumes resulting in higher production runs, higher degrees of local content breakdown, and improved production efficiencies;
2. more efficient production organisation, with more 'manageable' spares and components' stocks;
3. higher quality and/or lower prices arising out of scale efficiencies;
4. wider range of a viable local components owing to a larger local assembly activity;
5. higher level of local value added;
6. foreign exchange saving arising from the price differential between CKDs and CBUs, and higher levels of foreign exchange savings from increased use of local content;
7. improved export potential as showroom prices between locally assembled and imported vehicles narrows owing to various savings and price-quality benefits.(KMI, 1990)

The same report estimates that as of 1990, Kenya's total car population (excluding agricultural equipment and other vehicles) was approximately 115,000<sup>43</sup> with 90,000 of these being imported in 400 different models, while 25,000 were locally assembled in 50 different models. The scale economies given are 225 units/model and 715 units/model respectively. This implies that local assembly activities are relatively rationalised already. By use of forecasting techniques, KMI postulated that if total local assembly rationalisation were applied, and import restrictions were enforced, the distribution would shift in favour of local assembly, increasing the population of locally assembled units to 110,000 in 60 models and a scale economy of 1830 units/model. This has important implications for local industry. While not restricting consumer choice, scale economies would be achieved at assembly and components production levels.

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<sup>43</sup>. These figures take into consideration progressive scrapping of old cars, and the cumulative effects of model changes. They assume the same total annual market of 10,000 as at present (KMI, 1990: Section 8).

The auto-ancillary sub-sector, supplying the vehicle assembly industry with parts and components, already produces several items. According to the Kenya External Trade Authority (KETA, 1980), the government export promotion body, four stages in the vehicle manufacture and assembly process can be identified:

1. *Stage 1:* the manufacture of rubber, nylon or plastic moulded parts such as mats, bushings, mountings, covers, bellows, vee belts, etc.; panel mouldings; simple coiled springs and spring washers; exhaust and silencer systems; gaskets; shock absorbers; leaf springs; wiring harnesses; seats; cushions and auto trims; auto tyres and tubes; auto batteries; and miniature bulbs.
2. *Stage 2:* friction materials (brake linings, clutch facings); brake assembly; clutch plates and brake linings assembly; propeller shafts; steering gear, engine valves; spark plugs; pistons; rings and pins; dash board instruments; voltage regulators; distributors; head lamp assembly; wiper mechanisms.
3. *Stage 3:* die cast components; cylinder blocks; auto wheels; automotive gears; carburettors; auto starters; dynamos and alternators.
4. *Stage 4:* body stamping; chassis assembly; crank shaft forging and matching; fuel injection equipment; and metal bearing.

Almost all items in the first stage above are produced in Kenya, although with limited variety. Since the government's specific legislation mandating local sourcing, some items in stage two are also produced. A limited variety of spark plugs, brake linings and other friction materials are also produced. These locally available items are destined mainly for the replacement market. None of the items in stages 3 and 4 are produced in Kenya. Masai (1986) notes that the promotion of the development of these products has been restricted by, among others, the difficulty of achieving specialisation, efficiency and standardisation in a market that has a high proliferation of products. These developments present a vicious circle scenario. Because local producers predominately produce for the replacement market where consumers may not be discriminatory, and because of the lack of specialisation and standardisation, their quality is likely to improve slowly. This discourages, in turn, assemblers from procuring from these sources, leading to limited transfer of technology from the assemblers to local suppliers.

In summary, proliferation has deleterious implications for local small suppliers as the high variability makes it difficult to accumulate adequate experience and specialisation to achieve high quality standards. Problems associated with proliferation have been highlighted in the motor industries of other developing countries such as Latin America (Jenkins, 1977) and East Asia

(Donner, 1990), suggesting rationalisation as a strategy of achieving both scale economies and increasing local supplier capability. Consequently in the Kenyan case, in order to encourage local sourcing, one of the central strategies will have to be rationalisation of industry.

#### 5.6.6 INTER-FIRM LINKAGES IN THE MOTOR VEHICLE INDUSTRY

Although no studies have been conducted indicating the nature of inter-firm linkages in Kenya's motor vehicle industry, various authors highlight the nature of local content sourcing, a concept which is adopted by this study as a measure of outsourcing, and by extension, inter-firm linkages. As has been noted in preceding paragraphs, Masai (1991) notes the absence of significant sub-contracting activities

"Unfortunately, poor and inconsistent quality, uncertainty regarding supply, lack of practical standards for testing components, frequent changes in component designs slowed down progress in increasing local content. Sub-contracting was not done because the assemblers were seeking to improve product quality and productivity in their own installations." (p223)

However, his study is not supported by empirical evidence. Since this study, some sub-contracting has taken place within the industry, mainly owing to the effects of foreign exchange restrictions used by the government as a strategy to encourage local sourcing. This theme will be discussed further in the findings in chapter seven. In addition, other strategies to encourage the development of a local supplier base are being put into place. In 1992, for example, the director of the Kenya Industrial and Research Development Institute (KIRDI) announced that the Kenya government, in collaboration with UNDP, was planning to start formal manufacture of vehicle spare parts. He further announced that this would be undertaken through the recently established Engineering Development and Science Centre, which is part of KIRDI. This project was estimated to cost \$256 million and would utilise Computer Aided Design and Computer Aided Manufacturing technology so as to manufacture internationally acceptable products.<sup>44</sup>

Other forms of linkages are to be found in the repair and service sectors of the motor vehicle industry, perhaps the largest sub-sector in the industry. Again, these are neither documented nor formerly encouraged in national SME development strategies. *Jua Kali* repair workshops can be found all over the country repairing and servicing all kinds of vehicles and commercial vehicles using very limited capital and technology. However, it is not yet clear how these link with large firms.

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<sup>44</sup>. The *Sunday Nation - Life Style*, September 5, 1993.

## 5.7 SUMMARY

This chapter has addressed the context of the study, Kenya. Its development goals and strategies favour vertical de-integration of firms, and the development of small enterprises, suggesting that the country's industrialisation programme can benefit from current global developments where large firms are dis-integrating, and turning to inter-firm relationships to supply their requirements. For various reasons, SME development programmes and strategies in Kenya have not deliberately exploited this strategy. The question is how to achieve this in an environment where large firms are established and historically dominate and condition the social and institutional structures in the economy. In contrast, small firms are weak and few in number, particularly that category of formal, modern firms which have the managerial and technological capabilities for meeting the needs of large buyers in industry. Consequently, inter-firm linkages are likely to be limited on the grounds that local small firms cannot meet the requirements of large buyers. This research aims to explore, empirically, this and other pertinent factors limiting local sourcing, particularly from small indigenous firms.

In order to address the research question posed in the Kenyan context, chapter three will examine some of the literature explaining how and why inter-firm relationships are formed with the aim of exploring the factors which influence the formation of such linkages.



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## CHAPTER SIX

### RESEARCH APPROACH AND METHODOLOGY

#### 6.1 INTRODUCTION AND OVERVIEW

In any research, the research strategy used depends on the nature of the research question, and the ability of that approach to address the pertinent questions more accurately than alternatives (Denzin, 1978). It is also determined by the extent to which there exists knowledge about the subject, which may guide a more specific search for answers to the question (Yin, 1984). The alternative approaches to research include surveys, experimentation, a variety of case studies and case histories, and the analysis of archival information. Although these approaches are all used in contemporary research, the most frequently favoured approaches are the survey, relying on quantitative data, and the case study, generally relying on qualitative data. While surveys are favoured for their 'explanatory' properties (Yin, 1984) or in the study of static and stable forms of behaviour (Denzin, 1970), qualitative approaches using the case study are favoured in both 'exploratory' and 'explanatory' studies (Yin, 1984; Eisenhardt, 1989), or in processual analyses (Denzin, 1970).

This in itself does not indicate when to use surveys, experimentation, or case studies. The distinguishing factor is the question that the research seeks to answer. Yin (1984) provides a succinct schema which guides the choice of a particular approach to research. In summary, he argues that survey and archival analysis approaches are appropriate in 'who', 'where', 'when', 'how many' or 'how much' questions, while the experimental, historical analysis and case study approaches are appropriate for 'how' and 'why' questions since "such questions deal with operational links needing to be traced over time, rather than mere frequencies or incidence" (Yin, 1984:17).

Consequently, the case study is usually used where the survey or experimental approaches are not appropriate and vice versa. Investigators have, therefore, often pitted them against each other, yet these approaches are not mutually exclusive. Indeed, there are opportunities for multiple approaches in the same piece of research. For instance, Bourgeois and Eisenhardt (1988) have used case studies within a survey. There are also possibilities for using case studies within an experimental approach and vice versa. Hence, while one approach may predominate in a particular piece of research, other approaches may be used to augment that particular approach, suggesting



that in reality, they can be mutually dependent. Again, it is the nature of the research question which determines to what extent a combination of the two approaches can be used. In this research, a strategy which combines these approaches was planned to address the research at two levels. The case study approach was planned for the analysis of large firms given the small number of cases in the population of study, while the survey approach was planned for the analysis of their small firm suppliers who numbered, on average, 40 for each large buyer.

Case studies are often associated with 'qualitative' as opposed to 'quantitative' methods and data, which is associated with surveys and experiments. Two issues must be clarified at this juncture. First, while case studies more often than not use qualitative methods and gather qualitative data, they are by no means confined to this categorisation. Quantitative data can be collected within case studies. However, depending on the nature of the case study, it is difficult to perform statistical analyses of such data because the cases tend to be few in number or that data may not be comparable across cases. Qualitative data also lends itself to statistical analysis. Recent developments in qualitative research methods (eg. Glaser and Strauss, 1967; Yin, 1984; Miles and Huberman, 1984; and Strauss and Corbin, 1990) demonstrate that it is possible to analyse systematically qualitative data using a variety of regimes. Secondly, judgement is often made about the superiority of quantitative over qualitative data. While acknowledging the controversies in the literature (for example Eisenhardt, 1989; Yin, 1981b) it is important to note that the polarisation of these forms of data is somewhat artificial. Over the years social researchers favouring this methodology have tried to move away from the criticism that qualitative methods are simply exploratory, in effect neutralising their generative possibilities. Prominent in these debates have been Glaser and Strauss (1967) who argue in defence of case study and qualitative methods that

"there is no fundamental clash between the purposes and capacities of qualitative and quantitative methods or data. What clash there is concerns the primacy of emphasis on verification or generation of theory - to which heated discussions on qualitative versus quantitative data have been linked historically" (p17).

The orthodox case method is argued to be more expedient in focusing on the dynamics present within single settings (Yin, 1984, 1989; Eisenhardt, 1989:534). Yet, this approach has often been discounted by proponents of 'rigour' in scientific research as 'weak' on three grounds: (i) the lack of rigour emanating from the sloppiness of investigators; (ii) that case studies take too long to carry out and result in massive, imprecise reports; (iii) and more critical to scientific research, that they provide little basis for scientific generalisation, which arises from non-representativeness of the cases, and possible investigator and respondent biases. Without making excuses for some of the weaknesses of the case study approach, it can be noted that very rarely do these critics highlight

the rich qualitative data generated by this approach. Neither do they highlight the fact that all research approaches are susceptible to biases of one nature or another. For example, Sudman and Bradburn (1982) argue that during the design of questionnaires for surveys, biases can be introduced into what might be perceived as an 'objective' design. Rosenthal (1966) also highlights the dangers of bias in experimental research approaches.

Having said that, some researchers have still felt the need to move away from the orthodox case method. The traditional answer to the weaknesses attributed to the orthodox case study strategies enumerated above, is usually the survey method, arguing that its wider sample base, and its dependence on statistical sampling and analysis techniques, introduce more objectivity into a study. However, it can be argued that because of the generalisation levels achieved by the survey method, the richness of relationships and behaviour is lost. However, this chapter is not intended to add to the expansive literature which pits one approach against the other. Suffice is to say that many of the criticisms levelled at the case study approach have emanated from this misguided belief that the survey and experimental approaches are superior to the case study approach. Misguided in the sense that most criticisms are based on the analysis of particular methods of data collection, such as ethnography or participant-observation, which may require long periods of in-depth study, and emphasise detailed, observational evidence (Yin, 1984, 1989). Even these characteristics in themselves are not negative, but may become undesirable when they do not explicitly present the 'reality' of a situation, or result in laborious, unfocused results.

As noted in preceding paragraphs, despite this controversy, researchers in organisational behaviour have continued to use qualitative methodologies and data, particularly case studies, to explain various phenomena. For example, Eisenhardt and Bourgeois (1988) demonstrate in their research on coalitions in organisations that qualitative data is often particularly useful in explaining the underlying dynamics of quantitative data, explaining why or why not emergent relationships hold. Although this implies that the case study approach is used to augment quantitative methodologies, work by Yin (1981a), and also Pettigrew (1985; 1988) demonstrates that this methodology can be used independently to generate and test theory. Pettigrew (1985) also demonstrates in his study of organisational change in a British corporation, that the analysis of single settings can contribute fundamental insights and new theory.

In an effort to overcome some of the criticisms of the case study approach, the case survey method, developed by the RAND Corporation (an American Airforce organisation) in the early 70s (Yin and Heald, 1975) may be used. This method is basically a content analysis of cases based on pre-defined and pre-specified variables, rating them on a pre-determined scale. This means that (i) the case studies can be conducted to include specific variables rather than offer a merely descriptive expose; and that (ii) issues under discussion can be repeatedly studied for different

cases. This approach is further 'strengthened' by the use of more than one rater, then computing the inter-rater agreement indices (Eisenhardt, 1989). The multi-rater procedure uses several raters for each interview as a strategy for eliminating some of the rater biases that may arise. Once the scores are thus obtained, they are amenable to various types of quantitative analysis as are survey data. This would involve strategies such as content analyses of qualitative data. This approach would have been an appealing alternative to the single-rater approach adopted, but because of resource constraints, in addition to the difficulty of pre-defining and 'standardising' the rating scales, it was not used. It was also considered inappropriate to use pre-determined rating scales as it was felt that this approach would constrain the responses given by respondents. Hence, the variables suggested by the literature were studied across all the cases mainly to guide the information gathering process.

Another criterion often used to select the case study research design and method is the paucity of hypotheses which can be tested, hence, the use of inductive approaches to theory generation. As noted in chapters three and five, little is understood about the nature and extent of inter-firm linkage formation in the Kenyan context or indeed those of other developing countries. Consequently, hypotheses could not be readily developed for testing. Although, arguably, hypotheses could have been developed from existing European and American literature, two factors demand caution: there is the danger of transferring frameworks to environments that could be significantly different. As discussed in the literature review in chapter three, even the literature informing inter-firm relationship formation does not offer a comprehensive framework for the measurement of phenomena (Oliver, 1990). Consequently, the lack of developed knowledge, theory or methodology about inter-firm linkage behaviour, suggests an inductive approach (Glaser and Strauss, 1967; Paulin, et. al. 1982). According to Glaser and Strauss (1967), it is critical to formulate theory based on the context of investigation in order to generate substantive theory, and that

"substantive theory faithful to the empirical situation cannot, we believe, be formulated merely by applying a few ideas from an established formal theory to the substantive area." (p33)

Qualitative approaches are also often used when there are small numbers of cases in the population of interest, when it is considered inappropriate to use the survey approach for analysis of phenomena. Surveys aim to explore magnitudes, incidences, tendencies, and deviations from norms about a large number of sites in a given population. On the other hand, case studies aim to explore the dynamics of phenomena in single settings, hence offer this research this advantage. As noted in chapter five, the population of interest in this research has only a small number of elements - three motor assemblers and 13 franchise holders.

The research question in this study entails exploring the 'explanations' for inter-firm relations between large and small firms in Kenya. Essentially, therefore, the research question entails more than a mere quantification of phenomena (Yin, 1984). It involves an exploration of underlying reasons for the sourcing activities of large firms, those of their inter-firm linkages, if any, and the requisite conditions for formation of such linkages. Hence, because of this exploratory nature of the research, the small number of cases under examination, and the lack of specific testable hypotheses with regard to the research context, the case study approach was preferred.

## 6.2 THE CASE STUDY APPROACH

This study has used the case study approach in an inductive research process. The case research design often uses qualitative strategies for data collection. This form of research approach has become important in management research (Eisenhardt, 1989), and is increasingly used in other fields involving the study of organisational processes, such as entrepreneurship development and small firm research (Gibb, 1993). As organisations become more complex, current theory is viewed as inadequate in 'explaining' the complex and multiple realities of organisations (Morgan, 1980). Increasingly, therefore, researchers are turning to inductive approaches to theory formulation (Eisenhardt, 1989). Consequently, case studies have been used to accomplish various aims: to provide descriptions of phenomena; to test theory; or to generate new theory using inductive approaches (Eisenhardt, 1989). Although this research is mainly descriptive, it also generates some theory.

Since what goes on inside organisations is complex, simply enumerating 'how many' organisations exhibit a certain behaviour is not enough. More important is 'why' given situations arise. The ability to predict future occurrence of similar situations depends on 'why' any one case exhibits these tendencies, and not necessarily how many others have similar tendencies. In addition, each organisation presents a unique set of circumstances, reacting differently to its environment. As already stated, merely counting the incidence of a situation does not bring out its underlying explanations. Hence, it is erroneous to assume that statistical generalisations take into consideration the variety of peculiarities which are possible in a given population of organisations or indeed the reasons for such peculiarities. This question may be better answered by teasing out these underlying explanations by addressing the 'why' question. Glaser and Strauss (1967) also argue that the value of qualitative methods or case studies lies in their theoretical implications rather than the 'how many' question.

Two issues become critical in informing the design of case studies: the research question and its role in focusing the research; and the attempt to internally and externally validate the research.



### 6.2.1 THE RESEARCH QUESTION AND FOCUS

Like in all other research, in case study approaches, the research question is critical in focusing the research and its processes. It is even more critical in case study research in focusing the actual data to be collected and the actual process since, what is considered to be 'bad' research is often criticised for lack of focus because investigators avoid the definition of the scope of their research. Contrary to what critics of the 'grounded theory' or indeed qualitative research argue, its proponents do not attempt to study phenomena without a specific focus. By use of specific questions, they define the scope and focus of the research study (Eisenhardt and Bourgeois, 1988). Even the main proponents of 'grounded theory', Glaser and Strauss (1967), emphasise the importance of focus while warning against having 'tight' preconceived theories to dictate the research boundaries. They note that

"To be sure one goes out and studies an area with a particular sociological perspective, and with a focus, a general question, or a problem in mind. But he can ( and we believe should) also study an area without any preconceived theory that dictates, prior to the research, "relevancies" in concepts and hypotheses."(p33)

This does not mean that the 'advantages' of inductive research should be sacrificed for precision in question definition. Arguably, although existing theory is important in defining the scope of the research, the inductive approach requires that these theories do not restrict the 'deeper' exploration of phenomena. The research reported here has addressed some specific variables across several case studies in order to avoid laborious description devoid of analytical rigour. In emphasising the importance of focusing the study, it adopts Mintzberg (1979:585) contention that "no matter how small our sample or what our interest, we always tried to go into organisations with a well defined focus - to collect specific types of data systematically".

Hence, the study was focused by seeking to address a specific research question: *what are the underlying motivations for the sourcing strategies of large firms in Kenya's vehicle assembly industry, particularly with regard to their potential for inter-firm linkage formation between large and small firms?* This question was addressed by examining the nature of, and the reasons behind, the sourcing strategies of large firms in Kenya's vehicle assembly industry. While the 'incidence' question was pertinent, the central question was to hypothesise conditions under which large firms are likely to link with small firms using inter-firm linkage strategies such as subcontracting or licensing.

Further, although the study did not set out to test any specific hypotheses, the research process was focused by adopting a guiding hypothesis: *that large firms in Kenya's motor vehicle industry are more likely to internalise activities than externalise them. If they externalise and use inter-firm*



*linkages at all, this is likely to be more because of the perceived need to do so in order to gain access to inputs and markets, rather than the immediate cost reduction objective suggested in the literature* (Williamson, 1975). It can be expected that in the Kenyan context, for various reasons related to poor input markets, accessing scarce inputs is, perhaps, as critical, if not more so, than cost reduction *per se*.

### 6.2.2 VALIDITY OF CASES

A major aspect of quality control of any research study is its internal and external validity. Internal validity is relevant in explanatory or causal studies and not in descriptive or exploratory studies Yin (1989). It is the concern for the generalisability of the data results, by establishing a causal relationship whereby certain conditions are shown to lead to certain outcomes. On the other hand, external validity means establishing the domain to which a study can be generalised. It also refers to the extent to which inferences can be made from the data about the population of interest. Case study research fall within the descriptive or exploratory category, and is therefore less likely to be concerned with internal validity. However, external validity is to case study research what internal validity is to explanatory research.

The validity of case study research could be threatened by any number of factors, mainly those related to the design of the study and the actual process of data collection. Case studies have been criticised on grounds of laxity on validity arising from factors such as the absence of precise research instruments and factors related to case selection. In this approach, validity is threatened right through from design to analysis as the process of case research itself can be viewed as a continuous design activity (Yin, 1989:41). The following discussion attempts to address the strategies which this study has adopted to deal with such threats to validity: the selection of cases, replication logic, triangulation and the use of multiple case studies, and reliability. While internal validity was not of concern due to the exploratory nature of the study, external validity was critical. Also critical was the general reliability of the data collected.

#### *Selection of Cases*

As noted in the overview of this chapter, the main weakness attributed to the case study approach is its alleged lack of representativeness (generalisability), and the difficulty in identifying the specific biases of each case which impacts upon the external validity of the research study. Yin (1984) addresses this often cited limitation of the case study approach and provides a solution by arguing that:

"case studies, like experiments, are generalisable to theoretical propositions and not to populations and universes. In this sense the case study, like the experiment, does not

represent a 'sample' and the investigator's goal is to expand and generalise (analytic generalisation) and not to enumerate frequencies (statistical generalisation)". (p21)

This view is supported by others. For example, in order to disarm criticism on the basis of a lack of representativeness because the case study approach does not allow sampling, Eisenhardt (1989) asserts that it is neither expedient nor necessary to sample the population scientifically:

"the sampling of cases from the chosen population is unusual when building theory from case studies. Such research relies on theoretical sampling (i.e. cases are chosen for theoretical, not statistical, reasons....." (p537)

Although the cases maybe chosen randomly, random selection is neither necessary, nor even preferable (Eisenhardt, 1989). Having said that, because of the small number of cases in the sub-sector of interest, the question of case selection did not arise. In fact, the co-operation of the participating companies was an important factor in determining which firms would eventually be used in the study. In the preliminary stages of the study, all the assemblers and franchise holders were approached with the assumption that there would be a some degree of non-co-operation. In the final analysis, only those firms that could co-operate fully were followed up in subsequent interviews. As it turned out, those franchise holders/importers who co-operated were those contractors with a significantly larger stake in the assembly plants. However, in four out of twelve franchise holders approached, even the first interview did not yield adequate information for the investigation to proceed. In such cases, the firm was subsequently dropped from subsequent interviews.

Eisenhardt (1989) has also argued that it is to the advantage of the research to select cases which replicate previous cases or extend emergent theory, the "incremental approach to case selection", or tend to fulfil theoretical categories and provide examples of polar types. In this respect, representativeness is not a necessary condition. Because of the small number of cases in the population of interest, this strategy was not used. Instead, the study reported here has used case studies from a single sub-sector of the manufacturing industry in order to explore the theoretical implications of inter-firm linkages in this sector. Arguing that little is known about why firms form linkages with other firms in Kenya, particularly between large and small firms, the case study approach had the potential of exploring the various hypotheses about motivations for inter-firm linkages in the sector.

### *Replication Logic and the Multiple Case Study Design*

Another approach used to deal with possible threats to validity is to adopt the multiple case study design as a way of establishing theoretical representativeness rather than statistical

representativeness. Case studies do not seek generalisability over populations (statistical generalisation) but over theoretical propositions (analytic generalisation) as do experiments. He refers to this process as the replication logic as opposed to the sampling logic used in statistical generalisation. His example is useful in emphasising the point that replication occurs across the cases. He argues that

"if one has access to only three cases of a rare, clinical syndrome in psychology or medical science, the appropriate research design is the one in which the same results are predicted for each of the three cases, thereby producing evidence that the three cases did indeed involve the same syndrome. If similar results are obtained from all three cases, replication is said to have taken place. This replication logic is the same whether one is repeating certain critical experiments, is limited to a few cases due to expense or difficulty in performing a surgical preparation in animals, or is limited by the rarity of occurrence of a clinical syndrome. In each of these situations, an individual case or subject is considered akin to a single experiment, and the analysis must follow cross-experiment rather than within experiment design and logic." (p53).

Hence, each case study is used for its peculiar contribution to the research. The three main case studies in this research show significantly differing patterns of, and approaches to outsourcing, hence provide potentially diverse theoretical outcomes.

### *Triangulation and Multiple Data Sources*

Triangulation is a strategy which qualitative researchers often use to ensure both internal and external validity by eliminating some of the biases which arise from, and because of the research process. It involves the use of several data sources (respondents and/or secondary data sources) during field work, or the use of several data collection strategies. In her example, Eisenhardt (1989) uses triangulation of data collection strategies, arguing that when qualitative and quantitative data are used together, the qualitative data is useful in understanding the rationale underlying relationships revealed in the quantitative data. Yin (1989) and Denzin (1978), on the other hand, advice the use of triangulation by various data sources rather than various methods or approaches. Denzin (1978:295) adds, "by triangulating data sources, analysts can efficiently employ the same methods to maximum theoretical advantage". This study used such triangulation between various sources of information as well as between methods. Several data sources (respondents) were used in this study, which made it possible to corroborate information, or to underline some findings. On a second level, observation was used as a form of corroborating information about processes provided by respondents. In addition, it was possible to use some archival materials regarding the history of the firm.

### **Reliability**

Another quality control measure is the reliability of a piece of research: the extent to which the operations of a study can be repeated with the same results (Yin, 1989:41). One of the criticisms levelled at qualitative methods, particularly the case study method, is that there is a high level of 'subjectivity' emanating from the lack of 'objective' measures, among others. One way of dealing with this objection is to standardise the research procedures so that the data collection can be replicated. Data source and method triangulation are some approaches used by researchers such as Bourgeois and Eisenhardt (1988) and Denzin (1978) to address this problem. Other researchers have addressed it by studying specific constructs and variables across cases (Yin and Heald, 1975). This study 'standardised' data collection over the case studies by using an interview guide which addressed similar issues across the cases, although these were not treated as pre-defined but as potentially evolving during data collection to include variables not included (Miles and Huberman, 1984).

A second way is to study specific pre-defined constructs and variables as described by the RAND corporation in their Case Survey approach. Although the inappropriateness of using this approach has already been discussed in the introduction to this chapter, this study used its general logic of defining specific areas of enquiry. Consequently, the study explored the research question along three lines of enquiry, the nature and extent of outsourcing by large firms, the perceived factors influencing this behaviour, and the nature of relations which emerge. This way, it was possible to 'standardise' the research process and follow only particular variables over all the cases of interest, although care was taken not to confine the respondents to particular responses.

#### **6.2.4 THE RESEARCH DESIGN**

In the light of the above general discussion regarding the appropriateness of research design, the study adopts an in-depth case study approach. All three assemblers and four franchise holders in Kenya's motor vehicle industry (see chapter five and the section titled "*The Study Area*" of this chapter for an analysis of the structure of Kenya's motor vehicle industry). The four franchise holders (whose selection is explained in the section titled "*Selection of Cases*" of this chapter) represent the major contractors of two of the plants studied. This limited scope of the study has been conditioned by the research objectives, and various resource limitations to be discussed later in this chapter.

In the *first stage* of the study, expert opinion was sought from participants in Kenya's motor vehicle industry including government officials concerned with policy formulation and regulation of the industry; business associations concerned with representation and lobbying on behalf of various groups of members within the industry; and the firms which constitute the operational



sections of the industry (assemblers, suppliers, importers/distributors). This preliminary stage helped establish the scope of the study, and to formulate relevant questions for investigation.

In the *second stage*, in-depth case studies of the vehicle assemblers and their contractors were conducted using interview guides with open-ended questions. "Contractors" refers to the category of franchise holders who import CKDs and contract the assemblers to assemble them. The subsequent section - "The Study Area" explains how this category of respondent firms were 'selected' for inclusion in the study. The main rationale for this approach was to facilitate the generation of information without restrictions to sets of specific variables and constructs. However, as noted earlier in this chapter, in order to focus the study, specific issues raised in the literature and also by the preliminary stage of this study, were pursued.

In an attempt to balance the opinions about the issues under discussion, and determine the precise nature and benefit of the relationships to the smaller firm, the research design included a survey of the small firm suppliers of the major companies under investigation in the *third stage*. A questionnaire was developed and the names and addresses of the relevant suppliers obtained. However, as will be explained in chapter nine, this part of the study had to be aborted because of the poor response resulting from logistical difficulties.

The following paragraphs explain further this design by discussing the research process, explaining the rationale for the selection of the study area, and the various units of analysis.

### *The Study Area*

Although the selection of a study area is determined by the interests of the investigator, and the particular need to answer specific questions in that area, there are instances where there are no particular reasons other than those of convenience and accessibility of the research area. This study has elements of both. First, Kenya has been studied because the research problem was conceptualised within this context, although the applicability of the findings to other developing countries is envisaged. Secondly, because of the author's familiarity with Kenya, coupled with the requirements of the sponsors of the research, it was logical to situate the study in this country. The study was further contextualised within the motor vehicle industry in Kenya.

**Kenya:** In terms of theory building, Kenya has been selected because it is considered to be an example of a developing country which has, to date, adopted a variety of small enterprise development strategies which have not been as successful as anticipated, and has shown interest in promoting linkages between large and small firms through subcontracting and joint-venturing (GOK, 1989). The paucity of pointers as to how this could be done is a particularly appealing rationale for an investigation into the factors which could make this strategy realisable.



*The Kenyan Motor Industry:* Although chapter five has provided a more comprehensive analysis of Kenya's motor vehicle industry, its role in the research is discussed here. Despite its small size, the industry is important to Kenya's industrialisation because of its extensive inter-industry linkages described in chapter five.

The motor vehicle industry was selected for two main reasons. First, global developments in the motor vehicle industry offer a ready exemplar for inter-firm linkages. Hence, findings from the study could be compared directly with those in the vehicle industries of other economies. As discussed in chapter four, the changes taking place in the motor vehicle industry, globally, largely account for inter-firm linkages in this industry. It highlights the importance of this industry to the Japanese, American, British and German economies, and those of some developing countries such as those in South East Asia, particularly in relation to the extensive backward and forward linkages within the industry and with other sectors of the economy. During inception of a local motor assembly industry, the Government of Kenya acknowledged the potential for such linkages with other sectors, particularly with the services and metal working industries (GOK, 1974; 1983). This study, therefore, aims to contribute to the understanding of how this potential can be exploited.

Secondly, the sub-sector was topical in Kenya's industrialisation process when the study was planned. As part of the country's general industrialisation strategy, and particularly in an effort to promote small and medium enterprises, the Kenyan Government selected the motor assembly sub-sector to pilot the development of a sub-contracting exchange. The rationale provided by the project planners is based on the sector's potential for extensive backward and forward linkages as mentioned above. The Government of Kenya envisaged that the developments in the global motor vehicle industry, focusing increasingly on sub-contracting between various sizes of firms, if replicated in Kenya, would benefit the country's industrialisation (GOK, 1989). Until the establishment of this exchange in 1991, Kenya did little to utilise the potential offered by linkages between large and small firms. Together with a specific rationalisation strategy aimed at streamlining the motor vehicle industry and encouraging local procurement of components, this was expected to develop a local capacity to supply the vehicle assembly industry. Yet, it is recognised that there are policy impediments which prevent local assemblers from using local suppliers (Masai, 1991). Hence, for local small manufacturers to benefit from this strategy, the government has to focus on removing such policy impediments. The motivation of this study was to attempt, at least in part, to inform policy makers on how to facilitate such adjustments.

The Kenyan Government's interest in the motor vehicle industry is based on the sector's relationship with the manufacturing sector whose importance to the current study hinges on various reasons namely:- (i) Kenya's current concern with the development of export oriented industrialisation anchored in manufacturing, making all the sub-sectors in manufacturing

important in any plans for national development (GOK, 1989); (ii) the importance of the sector owing to its high contribution to GDP (only second to agriculture); (iii) the relative ease of physically locating manufacturing establishments because of their concentration in specific locations; and (iv) the amenability of manufacturing to isolation of various activities, hence opportunities for de-coupling and externalisation of activities are more immediately apparent in manufacturing establishments.

*Figs 5-1 and 5-2* illustrate the relationships between four categories of actors in the industry. Again, it must be noted that the fifth category of motor repair services has been excluded from this analysis because of its 'tenuous' links with the assembly activities as it mainly serves the used vehicle market. The other four participants in the sector are linked to the assembly 'core' through various ownership and resource use networks.

As shown in *Fig 5-1*, the four categories include the components sector, the importer/distributor sector, and the assembly sector (these are operationally two sub-sectors). Obviously, because the importer/ distributors sector are subsumed in the same firms, they are often considered as one category, whereas in reality, their impact on the motor vehicle industry can be delineated. For example, the importers form the core of the industry in terms of decision-making and determine what makes and models are to be marketed in the country. On the other hand, distributors impact on consumer demand. The assembly sector, although small in numerical terms, is the core of the industry in terms of productive organisation and value added. Yet, the full implication of its activities is likely to be missed because of the large proportion of used imports competing in the same market. According to KMI estimates for example, in 1990, about 78% of the vehicle population in Kenya was imported as Completely Built Units (CBUs). In addition, for an installed capacity of over 15,000 units per annum on a single shift basis, about 6,542 units were assembled in Kenya in 1992 (a drop of over 15% on the 1991 figures), given a new vehicle registration figures<sup>45</sup> for the same year were 22,000 vehicles (GOK, 1993). Nevertheless, the sector has continued to assemble vehicles even under such competition from fully assembled imports.

In these circumstances, it is evident that the 'power' to make sourcing decisions rests with the importer/distributor category. They make the major decisions in the sector regarding what makes and models to produce, as well as sourcing decisions. They also impact on the production scheduling decisions by determining CKD procurement scheduling, and marketing programmes. In this regard, they constitute a critical part of the study. The distributors form the next level.

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<sup>45</sup>. Note that these figures include new vehicles assembled and imported into Kenya, and any re-registration of Government vehicles converted to private use.

Given the intricacy of relationships between importers and distributors, it is often the case that the distributors are wholly or partly owned by the importing firms. Except for the case of GMK, all the importers/franchise holders have some ownership links with various distributors. The final level constitutes the component manufacturers. Due to the sourcing practices of importers and franchise holders, this category appears tenuously related to the rest of the motor assembly industry, largely serving the replacement market for vehicle spare parts (Masai, 1991:226). Currently, a large proportion of the components sourcing is from foreign suppliers either as part of the CKD kits or as separate transactions.

The three large motor assemblers in the sub-sector were studied. General Motors (K) Ltd., which is the only assembler and franchise holder in Kenya; Associated Vehicle Assemblers (AVA); and Kenya Vehicle Manufacturers (KVM) who are only contract assemblers, servicing about twelve franchise holders in the country. These firms are the only operators in the vehicle assembly sub-sector, and are considered to be large firms based on employment levels, capital investment and output. All of the firms in the 'assembler' and 'importer' categories were studied under the rubric of 'large' by virtue of their operations, and their impact on the motor vehicle industry. While other measures of size could have been used to discriminate between various sizes of firms, this was not done owing to the limited number of cases in the sector. Even if this were not so, the inadequacy or unavailability of data on investment levels or on output levels of firms would have made it difficult to use such measures of size. It was concluded, therefore, that the procedure adopted would not compromise the study.

### *Levels of Analysis and Study Units*

This study used the holistic case approach described by Yin (1989) as advantageous when "no logical subunits can be identified and when the relevant theory underlying the case study is itself of a holistic nature". The study reported here meets both conditions. In addition, the research question suggests that the dynamics of the whole organisation were in question, making it difficult to isolate units of analysis. However, various levels of response were used to explore, to a large extent, the broad spectrum of people involved in the decision to procure; make strategic changes to the organisation; and relate with external firms. Hence, while following the holistic level of analysis, the inputs to this analysis were solicited from various respondents and archival sources. This had the added advantage of circumventing one of the problems of holistic approaches: that of allowing the "investigator to avoid examining any specific phenomenon in operational detail" (Yin, 1989:49).

Because the research question sought to establish the sourcing behaviour of relevant firms, the first level is that of procurement of inputs, where the procurement officers were interviewed. The

second level of analysis was establishing from the Chief Executives their strategic intentions and actions. It is important to note that from an operational standpoint, it is difficult to separate the two levels since procurement behaviour is dependent on strategic intentions and strategic behaviour. However, it was necessary to separate these two levels for purposes of analysis.

### 6.3 FIELDWORK AND DATA COLLECTION

Fieldwork was conducted in Kenya between July, 1992 and January, 1993. Due to difficulties in obtaining access to some of the companies, considerable time was spent negotiating access. In addition, the prevailing political climate made it necessary to exercise caution during data collection. Nevertheless, care was taken to reduce the negative impact of these circumstances on the fieldwork.

After initial discussions with various government experts and participants in the industry about the nature and status of inter-firm relations between large and small firms in the industry, actual data collection in the firms of interest commenced (see section "*Selection of Cases*" above for 'selection' procedure). However, there was a continuous 'movement' between the firms of interest and these experts as a triangulation process which allowed corroboration of information provided by respondents from both categories. By this is meant continually obtaining data from all parties concerned throughout the research, as this became necessary. The process involved simply bringing into discussion with subsequent respondents, views which had been brought up by a previous respondent. In this way, it was possible to verify the information given in earlier interviews. It was also possible to go back to some respondents over the period of data collection for clarification, particularly those considered to have up to date expert opinion on the sector.

#### 6.3.1 DATA COLLECTION INSTRUMENTS

Case studies typically combine data collection methods such as archives, interviews, questionnaires, and observations. The evidence may be qualitative (eg. words) or quantitative (eg. numbers) or both (Eisenhardt, 1989). Data was collected by two main methods: (i) interview guides and; (ii) observation. The following is a brief discussion of these approaches.

##### *Interview Guides*

Qualitative methods benefit more from interview guides rather than from formal questionnaires (Yin, 1984; 1989). In this way adequate flexibility is built into the research process while allowing the research to focus on particular variables. While based on the literature review and the discussion with industry experts, all the interview guides and protocols used in this study did not set out to measure any constructs or to test any hypotheses, but rather to bring out the variety of



issues pertinent to large firm-small firm inter-relationships. Consequently, all of the interview guides consisted of open-ended questions.

Expert opinion was obtained from observers and participants in the industry through formal and informal discussions. Since this preliminary part of the research did not require precise measurement of constructs, the questions were necessarily 'open-ended' and organic. The interviews developed out of the discussion, although care was taken to keep the discussions within the scope of the study. It is also important to note that not all the 'experts' could provide the same type of information - their inclusion in the study was to provide breadth and depth of information. Hence, the direction and scope of the interview changed depending on what the 'expert' could contribute. This category of respondents was useful in two distinct ways: they provided information about general industry behaviour in addition to providing tentative views on the nature of inter-firm relations in the industry, particularly relating to subcontracting between large and small firms.

Two interview guides (Appendices B and C) were used - one for the assemblers and one for the franchise holders. One reason for having separate interview guides for the two categories was that the operations of both categories, particularly the relationship between procurement and production, are different. It was necessary, therefore, to ask different questions.

### ***Observation***

The second method of obtaining information was by observation, mainly as a way of triangulating the data collection process (Denzin, 1978:295). First, the assembly process was observed, 'following' inputs from the time the inputs arrived at the assembly plant, to the finished product ready for the distributors' outlets. While the production process itself was not particularly important for the study, it was necessary to establish at what points in the assembly process inputs were required, and what form these inputs took. For example, the imported CKD is in effect several groups of partially assembled parts and components requiring little, if any, additional local inputs (see Appendices A1-A3 for the CKD regulations and the description of various categories of items). Effectively, much of what may be referred to as 'local inputs' is, in fact, the labour of completing the assembly process, and those items included in the Legal Notices as outlined in Appendices A1-A3. This is important for the conclusions that may be drawn from the sourcing activities of assemblers or franchise holders.

### **6.3.2 DATA COLLECTION PROCESS**

The data collection process of any research study has significant implications for the internal and external validity of the study. The way access is negotiated, and interviews and observations



conducted, all determine the extent to which bias can be eliminated from the study. The following sub-sections discuss strategies used to avoid such bias.

### *Negotiating Access*

Denzin (1978) and others have argued that access to a research area or organisation is important in determining the extent to which the research can not only be facilitated, but also claim internal validity. Yin (1984) also adds that the way access is negotiated influences the outcome of the research, but he warns that care must be taken to avoid introducing bias arising from the investigator being influenced by the person or people facilitating access. It is also possible for the investigator to be tempted by the situation he/she is studying to voice his/her own opinion rather than present the facts of the situation as objectively as possible. Needless to say, the dividing line is thin, and it is entirely up to the investigator to guard against such influences.

Access to the organisations of interest was solicited on two levels. Initially, telephone calls were made to various firms in the industry requesting an interview with the Chief Executive, usually a Managing Director. In most cases, the investigator was referred to the firm's Public Relations department. In initial interviews with officials in these departments, the nature of information required was explained, and requests made for an interview with the Managing Director. Again, the investigator was often referred to someone else, usually the Company Secretary or the Procurement/Purchasing Officer. It must be noted that this was not altogether negative, because much of the company data was available at these levels. However, it was necessary to obtain general information relating particularly to overall corporate perceptions and behaviour. Consequently, further attempts were made to meet the CEO. In most cases, this bottom-up procedure was useful in gaining access to managing directors who would not otherwise have participated, particularly at a time when the industry was facing extreme uncertainty and depression and CEOs were reluctant to give interviews.

On the second level, it was realised that doing research in Kenya is difficult without personal contacts within organisations of interest. Hence, for those firms (three of the importers) that were found difficult to access, persons known to the investigator were contacted. The help of the Secretary of the Kenya Motor Industry Association was also solicited on the grounds that participants in the sector 'divulged' a relatively high amount of company information to him to facilitate compilation of industry performance reports. In addition, much of the industry background data was obtained from this source. This point is very important because, as already mentioned, obtaining company data in Kenya is extremely difficult. Needless to say, it was still difficult to arrange interviews with 'busy' executives. In many cases, it took at least three attempts to see an executive. Wondering about this difficulty, the investigator was informed by one

respondent that "off the record, the reason why you have not been able to get easy interviews is that, at this particular time, people are generally suspicious of people asking questions about their activities. Some of them [prospective respondents] are not being exactly straight in their [business] dealings!". Acknowledging this possibility, the investigator used methods such as engaging the interviewee in conversations about issues other than those directly related to the research, and gradually worked back to the study. Obviously, this meant that time investments were high. Having said that, what became clear from this experience was that in-depth interviews in Kenya require more than text book approaches. For example, people are reluctant to give straight answers to straight questions, hence most questions have to be modified during the interview depending on the preceding reactions of respondents.

### *Interviewing*

As mentioned above, interview guides consisting of open-ended questions were used at three levels of analysis:

- (i) Both formal and informal discussions were held with various industry experts including officials from the Ministry of Commerce and Industry; the Ministry of Planning and National Development; an official of Kenya Association of Manufacturers; an official of the Federation of Kenyan Employers; an official of the Kenya Subcontracting and Partnership Exchange; the Secretary of the Kenya Motor Industry Association; and official of UNIDO; several University of Nairobi lecturers who were involved in the National Car Project; and others directly or indirectly involved with the industry. These interviews not only provided an overview of the motor vehicle industry and the status of subcontracting and inter-firm linkages in the industry, but also helped focus the fieldwork.
- (ii) Based on specific variables deemed pertinent in the initial interviews with industry experts as outlined above, the Chief Executive Officers of the vehicle assembly firms and franchise holding firms were interviewed on strategic intentions, decisions, and pronouncements made by the firm.
- (iii) Also based on the variables identified in (i) above, the Purchasing and/or the materials handling officers were also interviewed. At this level, the extent and nature of transaction choices were examined, exploring the extent to which these officers followed precise economic or strategic rationale for procurement. The questions asked were initially direct, requiring information on ordering practices, etc. However, when it became clear that other factors affected the procurement decisions, the interviewing followed a probing pattern.

### **Observation**

To augment the information provided by the respondents, it was important to understand the production process. Time was spent, therefore, 'following' vehicles through the production chain to the distribution point. These observations provided valuable insights into the various categories of input sourcing, subassembly, assembly and distribution. This is important in understanding the production organisation within the sector.

This observation was able to identify four basic levels of operation for the assemblers (input procurement- subassembly - assembly - distribution), and two levels for the importers/franchise holders (inputs procurement - distribution). In essence, therefore, the importers, who are the main decision-makers in the industry, are essentially 'traders', while the assemblers, who make fewer decisions about the input and distribution, were the 'real' value adding agents.

### **6.3.3 FIELDWORK LIMITATIONS AND PROBLEMS**

In addition to the specific limitations noted already, it is important, at this juncture, to note some general ones affecting data collection.

*The prevailing political situation* - at the time of the study, Kenya was undergoing a significant political transformation-the transition from a one party state to a multi-party state. This transition has had a significant impact upon government policy, and also upon the stability of the business environment. Consequently, this impacted on the study on four levels. First, due to general uncertainties in the business environment, managers were generally reluctant to make long-term commitments about investments and strategic intentions. It was difficult, therefore, to obtain responses to questions regarding future action.

Secondly, due to uncertainties regarding the political implications of a multi-party Kenya, and its perceived implications for resource acquisition, it was difficult for firms to project demand or make strategic plans for the future. Hence, many managerial decisions at the time of the research were probably more opportunistic and defensive than they would have been otherwise.

Thirdly, the general liberalisation policy, adopted just before the commencement of the fieldwork in 1991, opened up a new set of opportunities and threats for many firms, particularly those dependent on imports of inputs. In effect, when this study was carried out, these firms were still in the process of assessing the effects of the policy changes on their operations. Since then, various changes have taken place in the industry, particularly resulting from the strong lobby by the Kenya Motor Industry Association. In June 1993, for example, the government repealed the legislation

mandating local sourcing as part of a wider programme to liberalise the economy. At the time of this research, however, the impact of this change was not yet clear.

Finally, the effects of the World Bank/IMF, and the Paris Club conditionalities for resumption of aid to Kenya, coupled with political instability in many parts of the country, have indirectly contributed to a generalised perception of 'insecurity' by the firms of interest. All of these factors have in effect made firms in Kenya generally cautious, making information gathering generally difficult.

*Uncertainties in the motor vehicle industry:* The extreme uncertainties within the industry at the time of the study, as discussed in chapter five, are likely to have had a negative impact on the study in the sense that managers could not make predictions about the business environment, or anticipate their own responses to it. Consequently, respondents were somewhat reluctant to discuss their strategies or their future actions as these were not immediately clear to them, or they felt that it was prudent not to discuss them in detail. Because all of the participating firms had been forced by economic circumstances to cut production by 40%-50% at the time of the fieldwork in the period 1992/1993, it was also probable that some of the behaviour observed was not typical. While the motor vehicle industry is still weak, it was envisaged by industry observers such as the Kenya Motor Industry Association (KMI), that it would stabilise somewhat in the face of the increasingly 'liberalised' business environment.

It must be pointed out at this juncture that the high uncertainty in the industry also contributed to delays in data collection. This meant that there were frequent lapses of time between various stages of data collection. In order to ameliorate the effects of this on respondents, it became necessary to recapitulate on previous interviews. Obviously, this increased the time spent on interviews. In a research recapitulation interview with the Secretary of KMI, he reported that "at the time, CEOs were trying against all odds to keep their heads above the water", therefore they could spare little time for interviews or completion of questionnaires. These developments in the research process serve to emphasise the general difficulty of obtaining data in developing country contexts.

#### **6.4 DATA CODING AND ANALYSIS**

The case study approach calls for analysis of data as the data is collected (Miles and Huberman, 1984; Strauss and Corbin, 1988; Yin, 1984). Iterative analysis of information gathered from each case was possible by transcribing the case material and checking it for content during the data collection process itself. This way, it was also possible to make decisions about who else to interview, or what other information to collect from other sources. It was also possible to corroborate information from respondents as the study progressed.



In addition, the conceptual analysis was conducted at the time of data collection. While some description of the cases is to be expected, the main analysis of the study appears in the form of cross-case conclusions (Yin, 1989:56). This obviously introduces a trade-off between the richness of contextual insights and the potential for comparative insights (Dyer and Wilkins, 1991:614). This dilemma was addressed by blending description (chapter seven) with cross-case analysis and conclusions (chapter eight).

## 6.5 SUMMARY

This chapter has considered the various alternative research approaches which could have been used, describes the approach used in the research, and also justifies the research design which has been adopted. The study, which focuses on the vehicle assembly industry in Kenya, adopts a case study design based on inductive approaches. Although this design, and indeed qualitative methods, have received criticism regarding 'scientific rigour', evidence has shown that this can be achieved with this methodology. By developing designs and methods which address the traditional criticisms, authors such as Glaser and Strauss (1967), Strauss and Corbin (1988), Strauss (1987), Yin (1984, 1989) and Eisenhardt (1989) have helped to bring the case study method into the convention of sociological research. These are taken into consideration in the research design adopted here.

A total of seven case studies (three vehicle assemblers and four franchise holders) in Kenya's motor vehicle industry have been used to explore the research question. It was also envisaged that the suppliers of these firms would be surveyed as part of the study. However, due to logistical difficulties, this part of the study was aborted. For the main study, background information has been gathered from various industry participants and observers in order to obtain a general sense of the nature of inter-firm linkages in Kenya, and the motor vehicle industry in particular. Interview guides, containing open-ended questions, have also been used to obtain responses from CEOs regarding company behaviour, Purchasing Officers, and Company Secretaries regarding the nature and motivation for sourcing activities of their companies. In addition, observation techniques have been used to collect information about production processes, and also to corroborate information provided by respondents. The cases have then been presented in descriptive form in chapter seven, and analysed in chapter eight to produce a set of cross-case conclusions.



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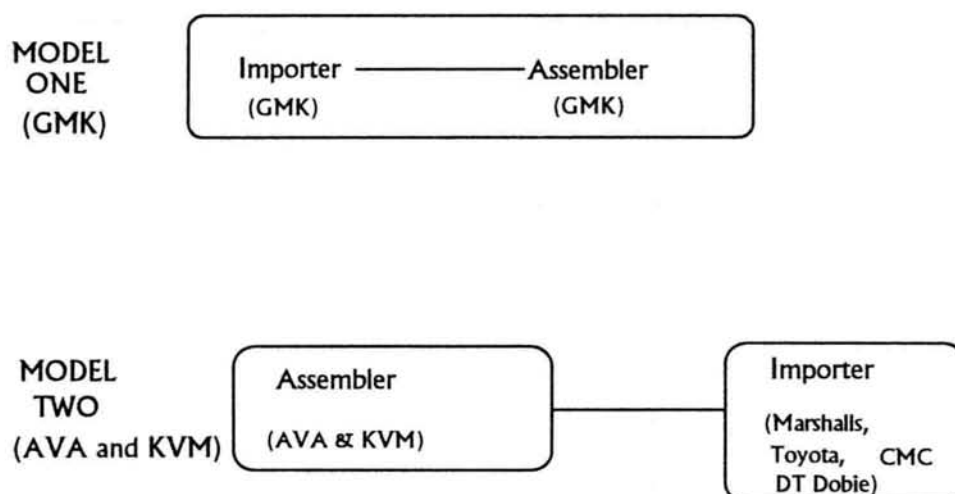
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## CHAPTER SEVEN

### RESEARCH FINDINGS

This chapter presents the research findings. In the three cases studied, two 'models' of production organisation were apparent. In the first 'model' (GMK), the sourcing and assembly functions are carried out by the same firm. In the second 'model' (AVA and KVM) the sourcing and assembly activities are carried out by separate firms with the functions of assembler and importer/distributor. These different scenarios present potentially different sourcing behaviour, supplier development activities and the use of local sourcing strategies.



Adopting what Glaser and Strauss (1967:101-116) term "the constant comparative method of analysis", the presentation of the case studies takes an interpretative rather than a purely descriptive approach. Campbell (1975) refers to this as "pattern matching" across different sites. Explaining this approach Miles and Huberman (1984) state:

The issue in the "pattern matching" approach is discovering whether a pattern found in one site plays in other ones as well, suggesting a common scenario. Are the same core variables involved? Are the ratings (high, moderate, low) the same?(p200)

Hence, the case analysis is concerned with establishing the nature of any existing patterns. The first case presents the GMK model where input sourcing and assembly activities are integrated. The second and third case studies present the AVA and KVM cases, each one including two

embedded case studies of franchise holders who perform the input procurement function. As discussed in chapters three and four, this has implications for production organisation in the motor vehicle industry - sourcing decisions are made by the importer who may or may not have equity in the assembly plant.

Four main variables are analysed across the cases based on the proposal that developing SMEs through linkages with large firms is predicated on the propensity and motivation of large firms to dis-aggregate, and outsource from small firms. Consequently, four themes are recurrent in the presentation of the case studies:

1. Is production organisation in the investigated firms conducive to dis-aggregation? This question was addressed by examining the way firms organise their production activities.
2. What is the nature of their input sourcing, and what are the motivations behind such sourcing behaviour? What are the factors influencing such sourcing behaviour?
3. What are their sources of inputs, and what is the nature of relations with suppliers?
4. What are their attitudes towards small firms as suppliers or partners?

## CASE ONE

### GENERAL MOTORS KENYA LTD. (GMK)

#### INTRODUCTION AND BACKGROUND

This case discusses General Motors (K) Ltd. in seven parts, highlighting its production organisation and its sourcing activities. Section two presents a brief background to the case. Section three discusses GMK's current production status, while section four addresses its sourcing activities. Section five explores GMK's buyer-seller relations, while section six outlines the nature of supplier development activities. Section seven presents those factors believed by GMK's managers to affect their sourcing decisions.

#### FORMATION AND OWNERSHIP

GMK is one of the three assemblers in Kenya's motor vehicle industry whose shareholders include GM Corporation of the United States<sup>46</sup> (44.5%); C. Itoh of Japan<sup>47</sup> (4.5%); Industrial and Commercial Investment Corporation (ICDC)<sup>48</sup> (46.4%); and ICDC Investment Company<sup>49</sup> (4.6%). The firm was established in 1975 and officially inaugurated in 1977, with an installed capacity of 4500 units per annum on one shift production basis, initially intended to serve the

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<sup>46</sup>. GMK's parent company GM Corporation, which is incorporated in the USA, is the largest automobile producer in the world. GM Corporation was set up in 1908 by William C. Durrant, and is headquartered in Detroit. It maintains manufacturing, assembly and distribution activities in 32 countries outside the USA and Canada.

<sup>47</sup>. C. Itoh and Company Ltd. is an integrated (trading) corporation with 760 affiliated companies world-wide, incorporated in Japan in 1949, which became a GMK shareholder in 1992. The company operates 203 offices in 87 countries, employing 10,000 people. Having started trading operations in Kenya as early as 1938, C. Itoh is currently involved in a wide range of activities ranging from importation of steel, construction machinery and equipment, and export of Kenyan coffee and other commodities.

<sup>48</sup>. This is a state corporation set up in the 1950s to manage state industrial and commercial investments in Kenya, specifically aiming at indigenising Kenyan industry and commerce. Recently, because of the World Bank demand for the dismantling of parastatals and state investments, ICDC has systematically reduced its investments in industry, only retaining investments in what the Government considers strategic industries. The car industry is one such industry.

<sup>49</sup>. This is a private investment company incorporated in Kenya in 1967.



commercial vehicle market. GMK started assembly in the early 1980s during the initial stages of the preparation to commence vehicle assembly in the country, having been one of the 16 firms to tender for vehicle assembly in Kenya, and was subsequently selected together with three others. GMK has continued to operate at levels ranging from 60%-80% excepting for recent poor performance owing to the general instabilities in the industry. In 1989, GMK was operating at 63% capacity, dropping to just over 30% in the 1991-1993 during the foreign exchange crisis in Kenya. Like the other assemblers, and according to the agreements with the Kenya Government, GMK initially assembled only commercial vehicles, making 4 and 3 ton trucks; the Isuzu pick-up trucks; buses; and over-7-ton trucks. As of 1992, this range included 30 Seater mini-buses, one make of a Saloon car (Opel Model T), and one make of Estate cars (Isuzu Trooper).

When Kenya moved into saloon car assembly, GMK was also among the first to import CKDs and assemble saloon cars. Its first saloon cars were produced in 1986 - the Isuzu (*Uhuru*), followed later by the Isuzu Trooper car. Unlike the other two assemblers, GMK does not have significant assembly contracts, if any. GMK is the only assembler hitherto assembling exclusively GMK held franchises.

#### PRODUCTS AND PERFORMANCE

Currently, GMK assembles vehicles in three categories. However, more than 90% of the company's products are commercial vehicle trucks, lorries and buses, mainly used in the agricultural, industrial and transport sectors. Below is a breakdown of the current categories of GMK products. Like all the other assemblers, it has had to expand its makes and models to meet the demands of the market. Consequently, GMK assembles at least 9 makes of vehicles, with diesel and petrol variants in the light truck and saloon car categories. As expected, this diversity of makes and models requires frequent changes in production organisation.

GMK is considered the industry leader in the trucks market, but has continued to perform poorly in the saloon car market. *Table 7-1* gives an indication of GMK's performance in 1991.

GMK leads in the over-7-ton truck category GMK, recording a market share of 73% in 1990 and 63% in 1991. This can be attributed to the popularity of the medium-sized bus sold only as a cowl for further body building and used extensively in the private transport sector. In contrast, the saloon car (large Saloons) category held a 5% share in 1990 for their Isuzu *Uhuru* model. Because of this poor performance, this model was phased out in 1992 and the Opel Model T launched. The potential of this model could not be ascertained at the time of the study because of CKD procurement crisis in the industry. GMK does not assemble any makes in the popular Small-Medium Saloons and Station Wagons categories. One possible reason for GMK's low market

share is its concentration on the assembly of only one saloon make at any one time, unlike all the other assemblers who compete in various market segments with a variety of makes and models.

**Table 7-1**      **GMK Products and Market Share (1991)**

Type	Make	Market Share GMK	Market Share Mkt. Leader
Large Saloons	Isuzu Uhuru	na	41%
4WD Estates	Isuzu Trooper	16%	46%
One Tonners	Isuzu TFR	18%	23%
Medium Buses	Isuzu NPR	87%	87%
Large Buses	Isuzu MT/MV	na	79%
Light Trucks	Isuzu NKR	44%	na
Seven Tonners	Isuzu HTR	63%	na
Ten Tonners	Isuzu FTR	27%	29%
Fifteen + Tonners	Isuzu FVM	15%	52%

*Note:* na - Data was not available

*Source:* Field Notes (1992/1993)

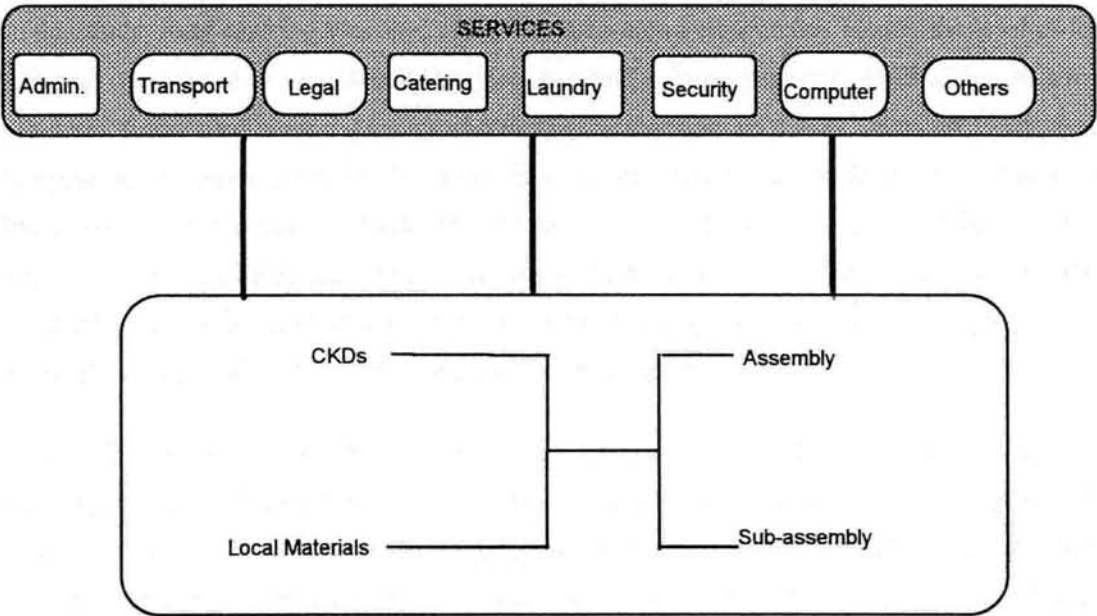
## PRODUCTION ORGANISATION

### ORGANISATION OF PRODUCTION ACTIVITIES

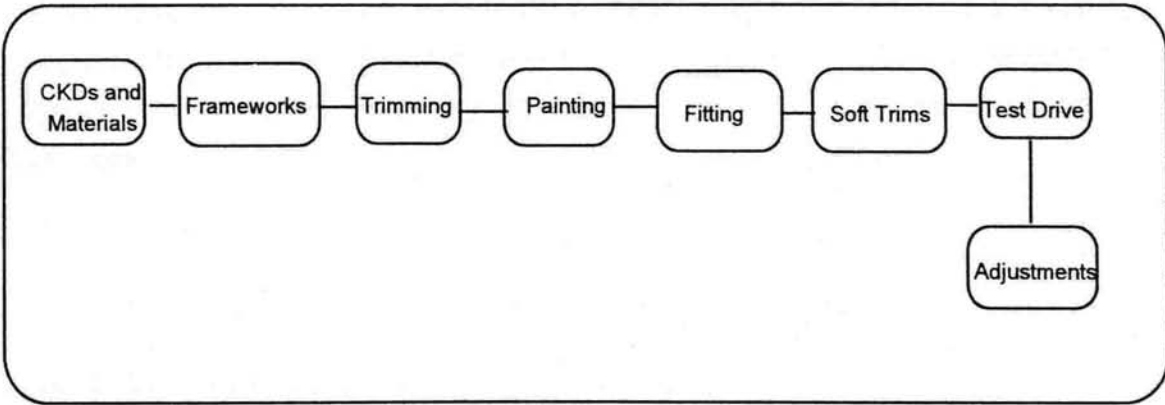
Production organisation differs significantly from the other assemblers. Its distinguishing factor is its combination of the assembly and input procurement role. As a result, its production organisation includes the sourcing of materials, assembly and marketing. However, GMK does not 'own' distribution outlets. Instead, its retailing and after-sales service activities are handled by dealers all over the country. *Fig 7-1* graphically illustrates this structure, highlighting the activity flows between materials sourcing and assembly.

Clearly, given this production organisation, GMK 'controls' a large part of productive activities. Unlike the other assemblers to be discussed later, this implies that GMK can be 'targeted' as a single entity when attempting to encourage inter-firm relationships with SMEs. Buyer-supplier relations, and issues related to quality and quality control can be managed between fewer participants.

*Fig 7-2* shows how the production outline functions. As can be noted, apart from the entry point for CKDs and materials, all other processes are relatively 'integrated', making de-coupling difficult. For example, once the shell has been welded together in the frameworks section, parts and components are simply fitted into it without any further manufacture or adjustment. It becomes difficult to de-integrate the assembly process.



**Fig7-1 Production Activity flows - GMK**



**Fig7- 2 Assembly Process outline - GMK**

## SOURCING ACTIVITY

### SOURCING BEHAVIOUR

In this study, local sourcing was used as a proxy measure of outsourcing. Hence, the level of local sourcing was used as an indicator of the extent to which a firm outsources. In all of the cases to be discussed subsequently, local sourcing is treatment in the same way. It is important to emphasise here that local content is used in this study in a general sense to imply all inputs obtained from local sources, rather than to mean only those locally produced. The main rationale for this approach is that the broad aim of this research is the development of SMEs, which can be found in commerce (import/export) as well as manufacturing and services. However, a finer measurement of local content would exclude imported inputs and services.

GMK utilises CKD materials sourced from Isuzu<sup>50</sup> (Japan), Adams Opel<sup>51</sup> (Germany) and some local inputs mandated in the import restriction legislation outlined in the Legal Notices no. 22 of 1980, 124 of 1986 and 245 of 1991<sup>52</sup>. Because of the recently opened up borders with South Africa, GMK has been able to source materials from Delta Motors (SA) for the Opel T-85 model. Other materials are sourced locally and also from offshore suppliers. None of the inputs are produced by GMK.

At the time of the study, CKD material accounted for 63% of the total cost of direct materials while local content accounted for 37%, including the labour charge. In addition, a large proportion of required services are provided in-house (80%). This is contrary to expected behaviour as posited by 'core competence' proponents such as Prahalad and Hamel (1990)- that a manufacturing enterprise is likely to outsource more services than it provided in-house. *Table 7-2* presents the outsourced parts and components, giving an indication of who supplies them, and an estimate of local content.

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<sup>50</sup>. Because Kenya is a right-hand drive country, GMK could not obtain CKDs from GM Corporation of USA. Instead an agreement was negotiated with Isuzu of Japan to supply CKDs to GMK. In addition to providing extensive technical training to GMK engineers, GMK uses Isuzu dealers in Kenya to distribute its products and also to provide after sales service.

<sup>51</sup>. GM Corporation of the United States has considerable equity interest in Adam Opel of Germany, as well as Isuzu.

<sup>52</sup>. See the appendices for the specific items contained in these notices.

**Table 7-2 Outsourced<sup>1</sup> Items - GMK (1992/1993)**

Item	Supplier	Estimated LC <sup>2</sup>
1. Oils	Kenya Shell Ltd.	10%
2. Greases	Kenya Shell Ltd.	10%
3. Fuels	Kenya Shell Ltd.	10%
4. Brake and Clutch Fluid	Kenya Shell Ltd.	10%
5. Sealers	Hardware Stores	0%
6. Adhesives	Hardware Stores	0%
7. Batteries	Chloride Exide	45-50%
8. Tyres	Firestone (K) Ltd.	10%
9. Tubes	Firestone (K) Ltd.	10%
10. Paints	Twiga Paints Ltd./ Sadolin Paints Ltd.	10%
11. Toughened flat glass	Impala Glass Ltd.	10%
12. Canvas hoods, covers & Screens	N/A	-
13. Soft trim and upholstery	Silentnight (K) Ltd./ Megh Cushion Industries Ltd./ Trimat Ltd/ Highway Cars	45-50%
14. Sound deadening materials	No supplier available in Kenya	-
15. Radiators	Burns and Blane/ Sagoo Radiators	20-25%
16. Exhaust pipes and silencers	Mann Manufacturing Co Ltd./ Setlak/Auto Ancillaries Ltd	100%
17. Leaf springs	AutoSprings Manufacturers Ltd./ Auto Ancillaries Ltd	0%
18. Spare wheel carriers	Pipeline Manufacturers Ltd./ Turn-o-Metal Engineers/ Patmose Technical Services Ltd.	100%
19. Seat Frames	Turn-O-Metal Engineers/ Silentnight (K) Ltd./ Megh /Cushion Industries Ltd.	100%
20. Wiring Harnesses	AutoSpring Manufacturers Ltd./ Automotive Products Ltd.	40-45%
21. Brake linings	Supplied with CKD	-
22. U-Bolts and U-Bolt Nuts	AutoSpring Manufacturers Ltd./ Auto Ancillaries Ltd.	0%
23. Disk Brake Pads	R B Shaw/ Varsani Brakelinings Ltd.	0%
24. Hydraulic Dampers & Shocks	Hill Products Ltd.	20%
25. Pre-mixed metal pre-treatment chemicals	Henkel (K) Ltd./ Twiga Paints Ltd.	0%
26. Windscreens, side and rear	Impala Glass Industries	0%
27. Radio and cassette players	Stenorrette/ Highway Radio Services	0%
28. Hydraulic Jacks	Turn-O-Metal Engineers/ Car and General Ltd.	0%
29. Spark Plugs	Car and General	0%
30. Speedometer cables	Express Moparts/ Burns and Blane	0%
31. Disk brake pad backing plates	AutoSpring Manufacturers Ltd.	100%
32. Seat belts	Megh Cushion Industries Ltd./ Burns and Blane	0%
33. Toolkits	Venus Industries	0%
34. Airfilters	Crossland-Autofilters Ltd./ Unifilters Ltd.	40%
35. Shackle pins for Leafsprings	AutoSprings Manufacturers Ltd/ Auto Ancillaries Ltd.	0%

<sup>1</sup>As noted in chapter five, this study used local sourcing as a proxy measure of 'outsourcing'. For purposes of this study, locally sourced inputs include all locally procured parts, components and services, including those imported by local dealers and supplied to the motor industry.

<sup>2</sup>These local content estimates were provided by GMK (the buyer). There may be slight variations reported by the suppliers. These items include all inputs purchased from outside GMK including those sourced from local importers.

**Source:** GMK Field Notes (GMK Internal Documentation) 1992/1993



As can be noted, all of the items in the list in *Table 7-2* are those contained in the Legal Notices (Appendix A). Except for the manufacture of jigs<sup>53</sup> from time to time, GMK has not voluntarily added any items to the list. Two reasons were given for this, namely: (i) it is difficult to develop suppliers from scratch to meet the quality standards required for GM products; (ii) it was more expensive to delete items from the CKD kits since Isuzu penalises any deletions while at the same time local products are significantly more expensive although, according to GMK managers, these are of relatively poorer quality. However, through the Supplier Development Programme, GMK is the only assembler actively involved in the improvement of the local suppliers of items listed in the Legal Notices. When asked why GMK finds it necessary to do so without any legal obligation, or immediate economic reasons, one manager remarked

"both in the short and long run, it is GMs interest to have good loyal suppliers of inputs. It is GM's global policy to develop local supplier bases, and so that is our imperative too."

#### MOTIVATIONS FOR SOURCING ACTIVITY

GMK's outsourcing behaviour is motivated by necessity - mandatory requirements by the government. Managers at GMK argued that in view of the current supplier infrastructure status, it is 'logical' to continue sourcing as complete a CKD kit as possible. However, one manager noted that despite this mandatory requirement, other internal organisational considerations have contributed to their sourcing strategy:

"we must think of car assembly in ten, perhaps fifteen years to come. If we do not develop the supplier base now, we shall be importing almost complete vehicles from abroad in ten years' time. That is not industrial development!"

Thus, GMK has an organisational intention to use external sources, viewed from a long-term perspective. Contrary to economic theories of short-term profit maximisation, managers at GMK see the future benefits of developing a local supplier base to be important.

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<sup>53</sup>. By 1992, GMK had built some expertise in the manufacture of jigs which they intended to export to sister companies in other African countries such as Nigeria, Tunisia, Zambia and Egypt.

**Table 7-3      Local Content Percentage of Cost Distribution (1992) for Selected Items (GMK)**

Item	%
1. Tyres and Tubes	4%
2. Trims	3%
3. Wiring Harnesses	2%
4. Springs	2%
5. Radiators	1%
6. Paints	1%
7. Metal Parts (e.g. spare wheel carrier	1%
8. Shocks and Jacks	1%
9. Others ( Batteries, glass, exhausts)	22%
<b>Total % Local Content</b>	<b>37%</b>
<b>Total % CKD</b>	<b>63%</b>

*Note:* All figures are rounded off

*Source:* Field Notes 1992/1993

## FACTORS INFLUENCING SOURCING BEHAVIOUR

As noted above, local sourcing levels were used as a proxy measure of external sourcing since most parts and components come as part of the CKD kit. Hence, while they do not provide the best fit, the factors affecting local sourcing were also used as a proxy for those affecting external sourcing, noting that some of the reasons for the limited use of local suppliers may be external. Managers argue that suppliers of the CKD kits often exert pressure, using deletion penalties, to coerce CKD buyers to buy complete kits. However, when asked what factors influence sourcing decisions GMK managers identified several general factors, and those regarding local sourcing in particular. These range from intrinsic weaknesses of existing and potential suppliers, to such external factors as Government regulation and foreign exchange restrictions. These are elaborated below.

### *Quality of local products*

The managers interviewed at GMK argued that while they would like to buy locally because of the proximity to suppliers (reducing the problems of lead-time, shipping costs, and losses through shipping mishaps), this is limited by the low quality of local products. This was further explained by the relatively higher standards demanded by the franchisors for their vehicles. Seven reasons were provided by the managers: the low technological capabilities of some local suppliers; the low managerial capacity of local firms; unavailability of skilled manpower to local suppliers; inappropriateness of machinery used for production in such firms; limitations regarding raw

materials; the use of obsolete production methods by suppliers; and the absence of testing procedures in these firms.

(a) *Technological capacity*: One of the issues affecting quality is the suppliers' technology. Put in one manager's words:

"Most local suppliers have old machines, measuring devices and tools, which are all inadequate to produce some parts to equivalent quality as imported products."

This problem is not restricted to small suppliers, but is more widespread within the sector, although the reasons for such inadequacies may vary. For example, when asked whether the technology problem was just a small enterprises problem, one manager remarked

"You will be surprised to learn that this is not peculiar to small businesses. I think it is one of the weaknesses of the Kenyan economy as a whole. Take for example, the case of laminated glass for car windshields. Since we started assembling vehicles in this country, we are not able to source this type of glass from Impala Glass Industries. They are a relatively large company!"

Another problem related to technology was related to the lack of technical assistance agreements between local suppliers and some component manufacturers in Japan or Germany - suppliers find it difficult to interpret correctly certain specifications and manufacturing methods. Most suppliers use their own technology and production techniques to produce a 'best fit' for what they interpret to be the technical specifications of a given item. One manager noted his surprise that given the level of technological development of some suppliers, they produce some of the complex items required at all. Needless to say, this does not take into consideration the possible penalties that may have been borne by the supplier in terms of inefficient production methods, and inappropriate sourcing of materials. However, at the time of the study, through their supplier development programme, GMK was making attempts to address this issue.

(b) *The management capacity of suppliers*: it was noted in various interviews that most of GMK's suppliers are small or medium family businesses which suffer from poor management capacity, particularly related to quality consciousness. Consequently, the quality levels of their products are perceived to be low.

(c) *Unavailability to local suppliers of skilled manpower*: because many local GMK suppliers are small family businesses, and because the small scale of operations does not allow reasonable profits, the type of employees they attract are of a lower skill level than is necessary to deal with the technological requirements of vehicle parts and components production.

(d) *Incompatibility of equipment*: in addition to the inadequacy of the technological capacity of some suppliers, the available equipment, usually obtained from Europe, is rarely capable of producing to Japanese specifications indicating incongruency of technologies. The example of radiators was used to emphasise this problem.

(e) *Quality of raw materials available to suppliers*: suppliers have limited control over the quality of the local raw materials they use in their production. One of the reasons issuing out of the interviews was the lack of proper standards in the country.<sup>54</sup> Consequently, local suppliers have not had adequate pressure to produce high quality products. According to GMK managers, this has also limited the extent to which parts and components can be standardised.

(f) *Production methods employed by suppliers*: suppliers are limited in their production methods, using, in some cases, rudimentary production techniques geared to small scale production. Coupled with inappropriate equipment and poor quality raw materials, the quality of end products is adversely affected.

(g) *Poor quality control and testing procedures by suppliers*: because of reasons mentioned above, suppliers do not have the capacity or the "consciousness" for bench testing of products to determine various performance characteristics. Consequently, there are some defects in products (estimated to be about 20-25% of delivered inputs) delivered to GMK. Although these are usually returned and replaced, there are significant costs in terms of time lost.

These observations have two major implications for GMK's operations: (i) development costs - if GMK is to benefit from such suppliers, she has to incur costs in improving the technology of potential and existing suppliers through production standards, and engineering support; (ii) high warranty costs - if these low technological levels are not addressed, there are high warranty costs emanating from high failure rates of parts and components. It must be noted here that this study did not intend to pursue the correctness of the statements made about the quality of products, but rather to those factors considered by GMK managers to be important in making sourcing decisions. In this case, therefore, it is the perceptions of the managers which were sought in this study.

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<sup>54</sup>. The Kenya Bureau of Standards (KBS) is the Kenyan institution charged with the duty of establishing standards and enforcing them. To date, the institution has had various problems in setting standards and enforcing them due to inadequate manpower. Appendix A2 shows those items used in the car industry, covered by the Kenya Bureau of Standards.

### *Lead-time*

The second factor mentioned regarding GMK's sourcing is the lead-time required between making an order and delivery for use in the production system. Sourcing from foreign suppliers requires, on average, a three month lead-time, yet, the fluctuations in demand are significantly shorter than three months. At the same time, because of the shortages in foreign exchange, opportunities for holding large inventories of CKDs are limited. This means that it is difficult to respond quickly to the fluctuations in demand patterns since inputs (including CKD kits) have to be built into the production system at least three months in advance. This is also affected by the lack of foreign exchange to pay for the order before actual despatch. This scenario implies that GMK has a critical internal incentive to source locally as much as possible.

### *Frequency of Engineering and Model changes*

Another factor argued to affect sourcing is the implications of the frequency of changes in makes and models owing to fluctuations in consumer tastes. The main effect on GMK's sourcing is the frequency of re-tooling (scrapping moulds and dies) by local suppliers, which not only creates considerable difficulties for the suppliers, but also complicates the process of supplier development for GMK. On the one hand, most suppliers are not flexible enough to re-tool at the rate at which makes and models change (at least once every year). According to one manager, some suppliers give up when they cannot cope with the continually changing specifications. In other instances, GMK has to terminate sourcing agreements when the supplier continually fails to meet GMK's requirements for quality, and delivery. On the other hand, even if they could re-tool as frequently as necessary, the costs are likely to be passed on to GMK.

### *Access to Foreign Exchange*

A fourth factor cited as affecting local sourcing is the unavailability of foreign exchange. At the time of the study, Kenya was experiencing an acute shortage of foreign exchange brought about by falling commodity prices on which Kenya depends for its foreign exchange; and the action taken by Kenya's major donors (The Paris Club and the World Bank) to stop providing quick disbursing funds to Kenya as a means of encouraging it to make substantial political changes. Three effects were cited by managers. First, this problem restricts the extent to which foreign suppliers can be used since the buyer may not be able to pay for CKDs in foreign exchange. However, contrary to expectations, this may not lead automatically to higher levels of local sourcing. Its effect is more generalised where the number of CKD kits which GMK can buy is reduced significantly, hence reducing the demand for locally sourced inputs. Thus, the lack of foreign exchange adversely affects the local parts and components industry by reducing demand for their output. Secondly, it limits the extent to which they can access inputs for their own production. Finally, currency



fluctuations vary the cost of materials from order to order. *Table 7-5* on price movements indicates that even when averaged over the year, some price fluctuations were very high. For example, the price variations in glass and exhausts went up by more than 400% between 1987 and 1988. GMK believe that this fluctuation is largely due to currency fluctuations.

The recent repeal in 1993 of the legislation mandating local sourcing, and the liberalisation of foreign exchange, it could be argued, is likely to increase the contracts that go to local suppliers. This may not necessarily be the case. Instead, most buyers can be expected to buy complete CKDs since deletions from the kit have attracted penalties from the manufacturers. In cases where items are not part of the CKD kit, there are possibilities that buyers will prefer to source from foreign suppliers based on the argument of quality already cited above.

### *Volume Levels*

The fifth factor relates to the proliferation of makes and models which is thought to limit the extent to which local suppliers can achieve economies of scale owing to the low volumes. Consequently, they [the suppliers] incur the penalties of small batch production and pass these on to GMK. In an interview, a manager at GMK noted that

"it is unreasonable to expect these people [suppliers] to develop reasonable quality standards and to offer competitive prices given the low volumes which they have to deal with. Take for example our requirements. We require at least 6 types of exhaust systems from our suppliers at any one time. The people [suppliers] have to supply perhaps less than 20 of each type in one order. Naturally costs go up because of such production runs."

### *Costs of local materials*

One other factor cited by managers at GMK is the high and transient cost of local inputs (see *Table 7-5* for a sample of price movements). Many of the raw materials used by local suppliers are imported and are, therefore, subject to duty and taxes. Hence, the actual products supplied to GMK are considered to be relatively more expensive than equivalent imported products. For example, while noting that these estimates were provided by GMK, only four of the 31 items outsourced by GMK used 100% local materials and labour, and as many as fourteen of the 31 items used no local material at all, except a small local labour content (*Table 7-3*). The estimates also indicate that only three items out of 31 use 40-50% of local inputs. This is an indicator that the perception by assemblers and franchise holders that local inputs reduce the competitiveness of the motor vehicle industry, may have some basis.

### ***Deletion Penalties***

GMK still pays to Isuzu a penalty for deleting (omitting) any item from the CKD. The effect of deletion penalties has concerned the motor vehicle industry for some time (Masai, 1991), arguing that the deletion penalties affect the assembler (or franchise holder) twice: first because of the penalties imposed by the franchiser; and secondly because of the higher costs of buying more expensive inputs locally. Similar to Masai's (1991) finding, it was found that the deductions from the cost of the CKD were far less than the price paid for the locally sourced item. Speculating how assemblers and franchise holders dealt with this problem, an official from the Ministry of Industry commented that

Assemblers find it very difficult to comply with the Legal Notice requirements because of the extra costs of buying locally. In order to beat this, they use some unorthodox methods. Some of them simply collude with potential suppliers to issue a *No Objection Certificate* for an item they would like to buy abroad, or retain in the CKD. Our [read the Government's] verification and policing system is so poor that it takes a long time to authenticate a claim that an item cannot be obtained locally.

However, because of the sensitive nature of this allegation, it was difficult to get direct answers from respondents.

### ***Single Sourcing***

Like other franchise holders, GMK has price-fixing problems with monopoly suppliers such as Firestone Ltd. (suppliers of Tyres and Tubes), and Hill Products Ltd (suppliers of Hydraulic dampers and shocks) - "they increase prices often, and without justification" (Interview Notes - Manager). From the interviews it was obvious that this was not the preferred position as GMK had little bargaining power. In addition to price negotiation and fixing problems, it was reported that single source procurement introduced uncertainties in the assembly process as suppliers did not take delivery schedules seriously. One of the reasons cited, from GMK's perspective, is the contention that monopoly status makes such suppliers 'arrogant' due to their relatively superior bargaining position. However, one manager conceded that it could also be due to the inability to cope with both original-equipment (OE) and after-market demand brought about by low capacity operation at the supplier's plants.

### ***Organisational Policy and strategy***

GMK's sourcing decision is also affected by global General Motors (GM) policy. GM has systematically followed a local supplier development policy in its global operations. Effectively, this global strategy accounts for GMK's use of local suppliers. The thinking behind it is the

argument that a local supplier base addresses the specific needs of the locality, and is, therefore, sensitive to consumer needs and close enough to operations to limit problems associated with distance. The advantage in the long-run is higher consumer benefits emanating from efficient analysis and solution of consumer problems.

**Table 7-4 Factors Influencing Sourcing Behaviour - GMK**

Quality	Cost	Availability and Reliability
1. Low technological capacity of suppliers	1. High cost of materials which suppliers use.	1. Small number of suppliers, in some cases tending towards monopolistic or oligopolistic markets
2. Low volume levels owing to proliferation of makes and models which makes it difficult for suppliers to benefit from experience.	2. Low volumes leading to higher cost of production - no economies of scale.	2. For various reasons, local suppliers find it difficult to meet delivery targets.
3. Poor management capacity of some suppliers, particularly related to quality consciousness.	3. High proportion of imported materials which suppliers use make local components relatively more expensive than equivalent imports.	3. Lack of access to foreign exchange by suppliers which causes delays in delivery.
4. Lack of skilled manpower of suppliers.	4. High duties and taxes charged on locally made inputs.	4. Foreign sourcing requires a long lead-time (3-6 months), hence local sourcing would be preferable.
5. Incompatibility of supplier's equipment to the needs of the buyer's specifications.	5. Monopoly suppliers charge high prices which shift constantly, thus introducing high uncertainty for GMK.	5. General uncertainties in the inputs markets make it difficult for local suppliers to fill orders to the quality, cost and delivery agreements.
6. Quality of raw materials available to suppliers	6. Deletion penalties by manufacturers discourage local sourcing.	
7. 'Backward' production methods employed by some (at least 80%) suppliers.		
8. Poor quality control and testing procedures by a large number of suppliers.		

*Source:* Field Notes 1992-1993.

*Table 7-4* summarises these factors into three main dimensions: cost, quality and availability. As can be noted, most of these factors are related to suppliers and their performance rather than GMK

itself or the business environment. Even in cases where the latter are important, they are interpreted in relation to the supplier - how they affect the performance of the supplier.

## BUYER-SUPPLIER RELATIONS

As noted in chapter four, the nature of buyer-supplier relations has implications for inter-firm relationships. Buyer-supplier relations between GMK and its suppliers can be described as arms-length. As can be seen from the *Table 7-2* above, GMK retains more than one supplier for all the locally sourced inputs except in those cases where a supplier holds monopoly power in an industry. The Supplies Manager argued that this was prudent as a safeguard against delays, failures to deliver, and unwarranted price increases.

In the case of single suppliers, managers at GMK were not happy with the 'lack of control' introduced in the buyer-supplier relations. In one case, GMK was concerned about the frequent and unanticipated increases in prices. As was noted earlier, relatively high cost is one of the factors identified by GMK managers as limiting local sourcing. Below is an indication of the proportionate price movements by various suppliers of inputs.

*Table 7-5 Price Movement 1987-1992 (Inputs for all models)*

Item Description	% Difference* 1987-1988	% Difference 1988-1989	% Difference 1989-1990	% Difference 1990-1991	% Difference 1991-1992
1. Tyres and Tubes	53 (>)	1 (<)	6 (<)	27 (<)	14 (<)
2. Glass	469 (>)	8 (<)	20 (>)	16 (<)	10 (<)
3. Batteries	62 (>)	9 (<)	6 (<)	28 (>)	12 (<)
4. Soft Trims	0 (<)	10 (<)	11 (<)	72 (>)	12 (<)
5. Exhausts	409 (>)	29 (>)	0 (<)	8 (<)	1 (<)
6. Springs	46 (>)	9 (<)	10 (<)	21 (>)	18 (<)
7. Harnesses	164 (>)	21 (>)	27 (>)	4 (<)	4 (<)
8. Radiators	77 (>)	13 (>)	12 (<)	9 (<)	21 (<)
9. S/Absorbers	115 (>)	104 (>)	7 (<)	23 (>)	20 (<)
Annual Inflation Rate	10.7%	11.0%	15.8%	19.6%	27.5%

\* This is the difference in the prices of items from one year to the next

(<) Compared to the annual inflation rates.

Source: Field Notes (Documents and Interviews) 1992/1993

Between 1986 and 1987, the price differential was high for all items except for soft trims, and continued to increase at a slower pace until 1991. Between 1991 and 1992, prices for most items

continued to increase but in any case lower than the official inflation rates. At the time of interview, GMK expected prices to increase even more due to the acute shortage of foreign exchange for suppliers to purchase inputs. Although the import restrictions had not been lifted at the time of the study (1992), speculation by the participants in the sector indicated that if this happened, some suppliers would take advantage of the situation to hike prices, justifying their action by arguing that prices in international markets were high. While it is still early to assess the effects of the recent repeal of regulations restricting importation, this prediction could very well be borne out.

A different problem tempering buyer-supplier relations relates to the adequacy and timeliness of supplies. According to one manager, because the supplier serves other assemblers, and also the replacement market, there are delays in filling orders. Although other factors were considered pertinent in explaining this position, managers at GMK believe that a lot has to do with the way local suppliers conduct business. In an interview, one of the managers in the procurement department remarked:

You have to be on the phone [to the supplier] all the time. When that fails, then you go to his premises just to remind him that you must have the order filled as quickly as possible. You would think that they have not had adequate lead-time for the order! The problem is that they do not take the order seriously until they have only a few days to the deadline. Then they cannot meet it [the deadline].

Another problem frequently associated with this was that of quality: because production was then rushed through the system, the pressure was on delivering the parts or components, and often, quality slips. Commenting on this, several managers cited this as one of the reasons why it was imperative that the Supplier Development Programme should focus on all aspects of the supplier's business rather than the engineering and production process alone. This implies that one of the problems facing local suppliers is their inability to organise production efficiently, most inefficiencies emanating from lack of professionalism. When asked whether the larger more 'professional' suppliers could be placed in this category of non-professionalism, it was clear that most managers interviewed at GMK viewed much of their [larger supplier] laxity as the result of their monopoly position.

## **SUPPLIER DEVELOPMENT ACTIVITIES**

According to Sako (1992) obligational relationships seem to increase inter-firm transactions, and buyers feel obligated to develop suppliers. As already mentioned, GMK has a Supplier Development Programme based on a supplier selection criteria developed at GM headquarters and adapted for the Kenyan firm. Of course, there are those suppliers who are not selected at all



because they are monopoly suppliers of particular products. For example, Firestone (EA) Ltd. is currently the only producer of vehicle Tyres and Tubes in Kenya. In such cases, all the buyers in the industry, including those in the replacement market, have no option. At the time of this study, Kenya had an operative restriction on the importation of motor vehicle tyres and tubes like several other products, hence there was no legal alternative. However, there are those smaller, less established suppliers who operate in more competitive markets and must go through a selection process. Suppliers are recruited by two main methods. (i) a supplier may approach GMK with a product it believes GMK needs, in which case GMK's engineers will examine its technical suitability and 'approve' it, perhaps *as is* or with some modifications; or (ii) GMK may request a potential supplier to produce a 'sample' of a product it requires, based on the manufacturers' specifications, either independently or with the help of GMK engineers. This initial stage is usually fully sponsored by the suppliers although they benefit from the specifications and standards provided by GMK. Each potential supplier is assessed individually, based on standard criteria used by GM affiliates globally. Essentially, the criteria include an evaluation of the technological, managerial and financial ability of the potential supplier to meet the quality, delivery and price targets of GMK. However, other specific requirements related to particular suppliers' circumstances are included. For example, in some cases, suppliers also serve the replacement market, and are therefore, likely to have operational problems in meeting GMK's demand. A team of engineers is involved in the supplier selection process together with the procurement managers in order to ensure a reasonable technical base of potential suppliers before they are accepted.

The selected supplier agrees to supply GMK, while GMK agrees to facilitate the technical development of the supplier if the nature of the products to be supplied is specific to GMK's needs. Currently, this process is carried out by means of an order. No formal contracts are used. This agreement does not bind both parties to specific volumes which are agreed for particular orders. This relationship cannot be described as a sub-contracting relationship because it is not governed by formal, binding contracts but by informal agreements to co-operate. Its vulnerability is emphasised even more by the multiple sourcing strategies adopted by GMK. Without a binding contract and given the ability of the buyer to shift from one supplier to another (superior bargaining position), suppliers are likely to be insecure.

Currently, supplier development is based on the needs of the supplier, and is therefore non-routine. If a supplier meets the requirements that GMK sets, then there is usually no involvement by GMK in the supplier's operations since the quality of products is checked on arrival at the GMK factory before acceptance. (However, when defects are noticed, usually in the initial deliveries, engineers are

patterns and tooling, to improve the supplier's efficiency. GMK managers see this as an assurance against poor quality. One manager remarked

"....if you want the best possible quality, it is not enough to give a supplier the technical standards and specifications. You need to help him 'clean' up his whole operation so that you are not just getting a good quality product, but getting it on time as well. That means that you must help him look for his engineering, managerial and stock control problems and find realistic solutions to suit him, and of course yourself."

This elaborate supplier development process is an indicator that GMK is making an attempt to build a reasonably reliable supplier base for its requirements. However, given the high costs involved and the continued perception that the government is not doing enough to support these efforts, it is possible that GMK might consider alternatives to local sourcing, particularly in view of the withdrawal of import restrictions. In an internal analysis of GMK's supplies status, such a possibility is seen in internal manufacture of components given that some of GMK's suppliers are owned by competitors<sup>55</sup>, which affecting its ability and capacity to negotiate with suppliers. The report notes,

"GMK can grow by getting into component manufacturing - more revenue, employment, profits." (*Internal Report, GMK*)

While there have not yet been problems, there are real concerns within GMK, so much so that in the report quoted above, this is given as a rationale for possible in-house production. Also pointed out is that other franchise holders are going into in-house production of components and parts, not only for their consumption but for the replacement market as well, as a means of expanding their company's profit base. These complications and insecurities are possible deterrents of an otherwise apparently 'positive' exercise.

Interestingly, GMK is aware that other franchise holders have not invested equally in supplier development, yet they [the other franchise holders] continue to use those suppliers developed by GMK. In fact one manager noted that the other franchise holders implicitly relied on GMs 'certification' of suppliers by sourcing from suppliers already approved by GMK. While this was acknowledged, there were no legal or technical restrictions on the suppliers to supply GMK exclusively. Neither were there discernible caveats imposed by GMK in cases where suppliers had multiple customers. This could be explained by the fact that GMK views the volumes they require

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<sup>55</sup>. For example, Burns and Blane, one of their radiator suppliers, is wholly owned by Toyota Kenya Ltd. (a Lohnro company). Autofilter, their airfilter supplier is owned by DT Dobie.

for prevailing demand levels to be too small to sustain their suppliers. That is not to say that GMK is primarily altruistic in their approach to sourcing. Management's expectation of future advantages based on the loyalty of suppliers is evident. According to one manager at GMK, in the event that the vehicle market in Kenya expands and their demand for parts and components currently sourced from suppliers rises, and given a scenario of limited supplies, the suppliers will be more loyal to GMK than to other buyers. To quote this manager, "we have developed some of these people from scratch. I do not think they will forget that quite so easily."

Having said that, it is probable that owing to short term benefits accruing to suppliers, particularly the small suppliers, it is unlikely that when asked to choose between customers they would choose those who have not made significant contributions to their growth. Obviously, this would also depend, in part, on the price differential.

## **BUYER PERCEPTIONS OF SME SUPPLIERS**

### **CHARACTERISTICS OF SUPPLIERS**

One of the objectives of the study was to find out the extent to which large buyers are willing to, and transact with small or medium firms. About 60% of GMK's suppliers can be described as small or medium firms. This is not accidental. According to one manager, the demand levels in the sector are so low that large firms have found it uneconomical to invest in the components sub-sectors. Most of the investors in this sector are, therefore small to medium firms. Those suppliers described as large are also monopolies in their industry. As a result, all the buyers in the motor vehicle industry have had no real options.

### **PREFERRED CHARACTERISTICS OF SUPPLIERS**

The study also sought to establish whether GMK preferred large or small suppliers, and why. A GMK manager reported that

"...all things being equal, it is much easier to deal with large firms as long as they do not have monopoly power. Larger organisations in our [business] environment can cope with the technological and volume requirements; small firms, as we discussed earlier, are still trying to establish themselves."

Hence, given prevailing circumstances, GMK would rather transact with larger firms for organisational and quality assurance reasons. The same manager was keen to add that large firms do not necessarily mean lower prices [often assumed to result from higher volumes]. He argued that on the contrary, owing to their monopoly position, and resulting inefficiency, large firms are likely to charge higher prices.

## **FORMING INTER-FIRM RELATIONSHIPS WITH SMES**

GMK is perhaps the only vehicle assembler in Kenya with a specific policy to develop local suppliers, and to use them for input requirements. As is discussed in preceding paragraphs, this is due to the global General Motors corporate policy to develop local suppliers in their respective countries of involvement as an assurance against the high costs of 'foreign' sourcing.

According to GMK managers, this is currently hampered by lack of institutional and infrastructural support by the government for firms that wish to 'upgrade' the productivity and quality standards of local suppliers. They also argue that small local suppliers are particularly affected because of their lack of access to technology, finance, manpower, and foreign exchange for the procurement of inputs.

## **SUMMARY AND CONCLUSION**

This case described and analysed the production organisation of GMK highlighting factors influencing its sourcing strategies. It reveals that GMK is relatively integrated in the sense that many of its requirements are produced in-house, except for those items mandated in the Legal Notices, and some services. Reasons provided by the study range from the inadequacy of the supplier base to the reluctance of its CKD kit suppliers to delete more items. It also reveals that GMK already uses a supplier development programme as a strategy to build a local supplier base. Its relations with its suppliers is relatively arms-length in nature, characterised by multiple sourcing and relations lasting the duration of the order. This implies that there is some potential for future transaction but this could be limited by the arms length approach to inter-firm relationships.

## CASE TWO

### ASSOCIATED VEHICLE ASSEMBLERS (AVA)

#### INTRODUCTION AND BACKGROUND

This case describes and analyses the activities of Associated Vehicle Assemblers (AVA), one of the three vehicle assemblers in Kenya. The presentation differs from that of GMK because AVA is a contract assembler, and its activities are tied to those of the franchise holders (contractors), Marshalls (EA) Ltd. and Toyota (K) Ltd., which are presented as embedded case studies. These two cases were selected from seven franchise holders served by AVA because, together, they constitute approximately 70% of AVA's total annual output.

The case will be divided into three parts for ease of presentation of empirical data. The first section will describe AVA as an assembler, part two will present Marshalls (EA) Ltd, while part three will present Toyota Kenya Ltd.

### I ASSOCIATED VEHICLE ASSEMBLERS (AVA)

#### BACKGROUND

##### FORMATION AND OWNERSHIP

After a joint venture agreement between the shareholders was signed in 1975 for its establishment as a multi-franchise plant, AVA was established in 1977, with an installed capacity of 12000 units. In 1987, 80% of this capacity was being used. However, owing to industry problems at the time of the study, only 30% of capacity was in use. In 1987 AVA held a capital investment of KShs. 120 million (out of a total industry investment of about KShs. 990 million) with a government share holding of 51%. The anticipated equity structure after completion of the ongoing programme of privatisation of public investment is expected to change significantly with the transfer of government equity to private Kenyan shareholders. The equity of the other shareholders remains the same while the government's shareholding reduced significantly. *Table 7-6* shows the equity structure of AVA in 1992, the time this study was undertaken. It is important to note that because



the government considered it to be a strategic industry, it invested in all of the vehicle assembly plants in joint venture agreements with various foreign and local investors.

**Table 7-6      Ownership Structure of AVA**

Industrial Development Bank	25%
Treasury*	26%
Inchape Ltd (Marshalls (EA) Ltd.)	24.5%
Kenya Motor Holdings (Toyota Kenya Ltd.)	25%.

\* When the field work was carried out (1992), this holding was scheduled to go to private investors as the government privatised its investments.

**Note:** Marshalls (EA) Ltd. and Toyota (K) Ltd. are major franchise owners.

Marshalls (EA) and Toyota (K) are AVA's main contractors. Although together they hold only 49% of the equity, they have a significant influence on the assembler's activities because AVA is largely dependent on them for its operations. Hence, strategic decisions at both firms significantly influence AVA's decisions. For example, the importers decide what makes and models are to be marketed and hence determine, to some extent, AVA's production operations. According to one manager, "they [importers] bring their requirements, we build them!". Essentially, importers provide the assembler with their requirements, complete with delivery schedules, and provide the CKDs and other materials required for assembly and subsequent distribution.

## **PRODUCTS AND PERFORMANCE**

Currently, AVA assembles upto 62 different vehicle makes and models for seven importers/franchise holders. This is, in fact, the highest mix of makes and models of any assembler in Kenya's motor vehicle industry. Consequently, AVA is affected even more than the other assemblers by the proliferation of vehicle types. *Table 7-7* shows the various products and contractors. AVA has a total of six assembly lines, each capable of adjustment to produce the particular make or model introduced on the assembly line. Given the wide range of its contractors (seven in 1992), demands for flexibility are high.

**Table 7-7**      *AVA Products and Contractors (1992)*

Importer/Franchise holder	Vehicle Type/Make
1. Ryce Motors Ltd.	1. Daihatsu Charade 2. Rocky 4WD
2. Kenya Motors Ltd.	1. Fiat Iveco 2. DAF bus 3. Fiat UNO passenger car
3. ECTA (K) Ltd.	1. Subaru saloon
4. Bruce Trucks and Equipment Ltd.	1. Mitsubishi Fuso 2. Mitsubishi buses 3. Mitsubishi prime movers 4. Lada 5. Hino
5. Marshalls (EA) Ltd.	1. Peugeot 504, 505, 205, 405 2. Peugeot 504 pick-ups 3. Volvo trucks
6. Toyota Kenya Ltd.	1. Toyota Corolla 2. Toyota Land Cruiser 3. Toyota Panel Van 4. Toyota Estate 5. Toyota Hilux pick-up 6. Hiace mini-bus 7. 3 ton DYMA trucks 8. Buses
7. Simba Colt Motors Ltd.	1. Mitsubishi Lancer saloon 2. Mitsubishi pick-up

*Source: Field Notes (1992/1993)*

AVA's performance within the industry has been largely based on its assessment of the combined requirements of its contractors. However, based on total makes from various franchise holders, AVA has the highest assembly output in the sector. In 1987, for example, AVA produced 4,600 cars compared to the 4,300 and 2,800 units produced by KVM and GMK respectively. This is not surprising considering that AVA has the largest number of franchise holders and assembles the largest mix of makes and models. In the same year, AVA also recorded the most efficient operation in terms of capacity utilisation among the three assemblers. For example, *Table 7-8* shows the relative performance of the assemblers in terms of capacity use and output in 1987.

**Table 7-8**      *AVA's Performance - Capacity Utilisation and Average Output (1987-1990\*)*

Assembler	Output (units)	Capacity utilisation (%)
AVA	4600	80%
GMK	2800	63%
KVM	4300	74%

\* Owing to industry-wide difficulties, production had fallen to less than 50% for all assemblers between 1991 and 1993.

*Source:* Field Notes (1992/1993)

## PRODUCTION ORGANISATION

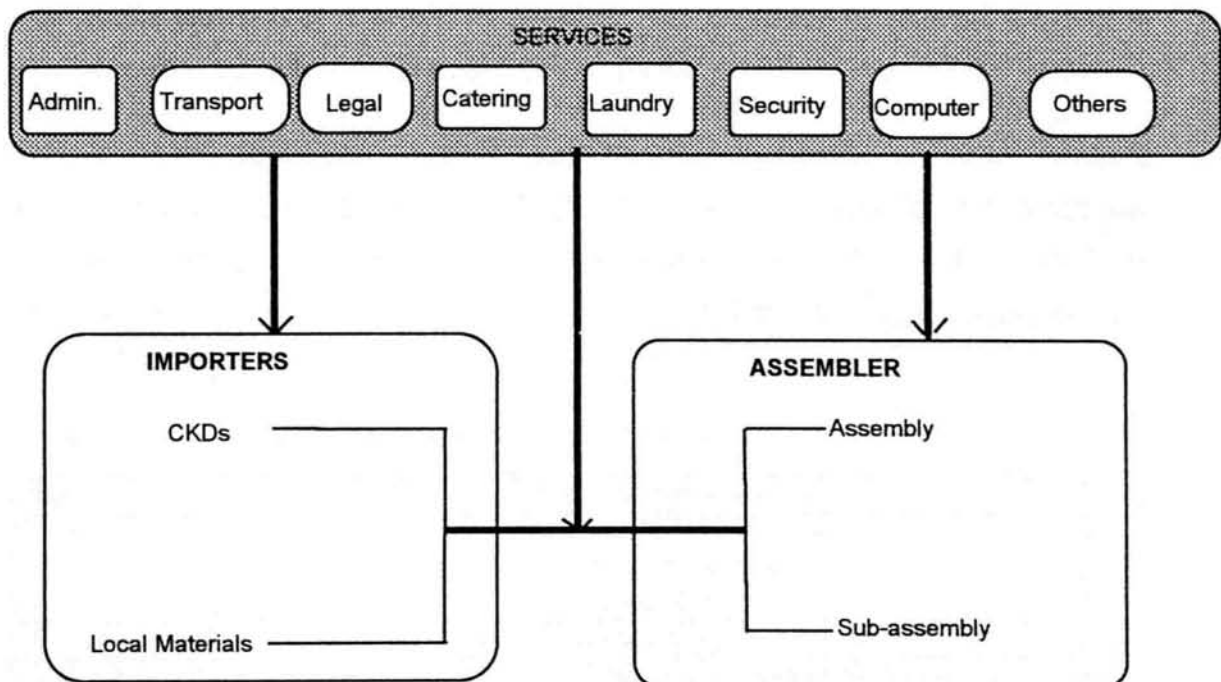
### ORGANISATION OF PRODUCTION ACTIVITIES

AVA is organised around the assembly activity, with other activities entering the assembly line at various stages. The assembly line itself is completely flexible, allowing the assembly of a variety of makes and models over short periods of time. The CKDs and materials are delivered to the plant by the importers (or their agent). These constitute the main inputs into the assembly process, with an input of services at all levels. For example, the security services which are vital to AVA's activities due to its responsibility to importers, goes into all levels of the process. Laundry, security and insurance services are bought in, while legal, and information services are provided in-house with occasional consultancy services used when necessary. AVA has no further involvement beyond the assembly process - i.e. distribution and after-sales service activities are handled by the importer/franchise holder. Prospects for outsourcing, therefore, may be only possible in the assembly channel in the form of sub-assemblies, yet, this is limited by the CKD procurement policy which 'forces' importers to buy-in as complete a kit as possible. *Fig 7-3* describes AVA's activity flows.

Clearly, this mode of production organisation differs significantly from that reported for GMK. The main implications in this 'model' regards the procurement function. By separating procurement from assembly, it is difficult to target the assembler with regard to SME development. First, more actors are introduced into the 'equation'. Secondly, the assembler is removed from the supplier chain decision-making process. This has implications for the concepts of quality, delivery, and buyer-supplier relations. The assembler has limited involvement in the procurement, quality control and delivery of vital inputs. Consequently, the success of supplier

chain management depends on closer association between the franchise holder and the assembler, and between the franchise holder and the input supplier.

In order to allow work to be organised to suit the requirements of new makes and models, AVA's assembly line itself is flexible. For example, jigs and related equipment can be moved from one production line to another. They can also be adjusted at short notice to cater for variations in specifications. However, the process of assembly itself is integrated. For instance, once a kit goes onto the assembly line, little else goes into it in terms of sub-assembly or specific inputs, except for various services. This results from the fact that the assembly kit arrives at the plant in a relatively complete form - including already assembled sub-components such as gear boxes, engines and chassis. Hence, there are few prospects for outsourcing at this level. *Fig 7-4* shows the activity flows within the assembly process itself.



**Fig7-3 Production Activity flows - AVA**

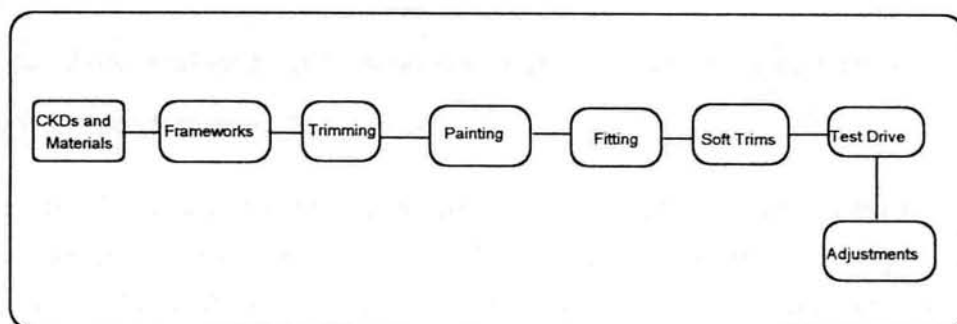


Fig 7-4 Assembly Process outline - AVA

## SOURCING ACTIVITIES

### SOURCING BEHAVIOUR

As already noted, owing to its contract assembler status, AVA does not source CKDs and local materials directly. In the Assembler-Importer Agreements, the assembler relies heavily on the importer for the provision of materials for assembly. The discussion of sourcing activities is presented, therefore, under the specific embedded case studies.

However, the same agreement gives the assembler the opportunity to source whatever 'consumables' are agreed with the importer. Hence, AVA sources whatever other materials and inputs as are considered non-specific to a particular importer/franchise holder. These items are purchased on order in a routine way. At the time of the study in 1992, the following materials were being sourced directly by AVA.

**Table 7-9**      *AVA Outsourced Items\* and Suppliers*

Item	Source (size of supplier)
1. Paints	1. Sadolin Paints (Large) 2. Twiga Paints (Large) 3. Berger paints (Large)
2. Oils and fuels	Esso Ltd. (Large)
3. Welding Materials	1. East African Oxygen Ltd. (Large) -60% 2. Imported (Various sources) - 40%
3. Paintshop Chemicals	Henkel Ltd. (Large)
4. Sealers and Adhesives	1. Henkel Ltd. (Large) - 20% 2. Dunlop Ltd. (Medium-Large)- 20% 3. Sadolin Paints Ltd. (Large) - 20% 4. Imported - 40%
5. Tools (e.g. spanners, hydraulic jacks, etc.)	Various importing merchants (Large-Medium)

\* 100% of all the items is bought-in.

**Note:** (i) AVA has no ownership interests in any of the supplier firms.

(ii) All of the listed items appear in the Legal Notices nos. 22 and 124

**Source:** *Field Notes (1992/1993)*



Clearly, only those mandated items are outsourced, mainly from large or medium firms.

### **MOTIVATIONS FOR SOURCING BEHAVIOUR**

As can be noted from the discussion in the preceding paragraphs, sourcing behaviour at AVA leans more towards external sourcing, not from local firms, but from manufacturers of products and components abroad. AVA managers cited several reasons for their sourcing behaviour. First, because Kenya does not manufacture vehicles, importation of the CKD is a rational behaviour by all assemblers and their contractors. Thus, AVA's sourcing behaviour is motivated by lack of internal capacity to supply parts and components. Secondly, owing to various reasons hindering local sourcing, mainly hinging on the weakness of the suppliers, assemblers are 'forced' to import most of their requirements. Finally, the only outsourcing taking place is that which is mandated by the government. However, in the case of services, outsourcing is influenced by lack of internal capacity and the expense of having such in-house facilities given the low transaction levels of such services.

### **FACTORS INFLUENCING SOURCING BEHAVIOUR**

As already noted, this study has used local sourcing as a proxy measure for outsourcing. Consequently, sourcing behaviour is defined in terms of local Vs foreign sourcing. AVA managers reported that three main factors were important in determining sourcing behaviour:

- (i) "for most items including the CKD kit, that decision is out of our hands! The importers buy almost all inputs"; however, for those items sourced by AVA,
- (ii) "it is important to comply with government requirements to source locally those items appearing in the Legal Notices";
- (ii) "since AVA does not have the capacity to produce many of the items deleted from the CKD kit, the only option is to buy from other suppliers."

Evidently, AVA's sourcing behaviour is circumscribed by its ability (based on its relationship with its contractors) to make sourcing decisions about various inputs. However, for those items it has purchasing jurisdiction over, AVA managers thought that compliance with government legislation was a very important part of its strategy. The MD at AVA remarked "when you locate operations in a particular country, it is incumbent upon you [the firm] to try and work within the legal framework of that country, or else you become counter-productive. In the long-run it is not healthy to contravene regulations."

The following specific factors were mentioned as influencing the choice to source locally or from foreign suppliers. These are similar to those reported by GMK, but may differ in their intensity or their perceived impact.

### *Quality*

AVA's primary concern is with the quality of its final products. It is, therefore, upon this interest that selection of suppliers for those items sourced directly is made. For example, AVA imports a significant proportion of sealers and adhesives and welding materials (40% of total requirements in each case). One of the reasons given for this is that some particular types of materials cannot be obtained locally - their quality is perceived to be either too low, or the suppliers are judged unable to supply the quantities required.

### *Frequency of engineering and model changes*

The first case study described in this chapter revealed that GMK is affected by frequent changes in engineering requirements brought about by constant makes and model changes which in turn, affect sourcing, particularly limiting the reliability of local suppliers. However, AVA is not directly affected by this phenomenon in terms of sourcing and production scheduling. Instead, it has more operational implications for AVA. Because AVA transacts with so many franchise holders at any one time, it has to adopt a completely flexible assembly system to allow for such frequent changes. According to the production manager, "any type of vehicle can be brought here for assembly. We have no control over what makes and models we assemble, so we have to be prepared." For AVA, being prepared means being flexible enough to accommodate these changes. It also implies that linking the supplier's schedules to their own requires the adoption of different production organisation patterns.

### *Access to foreign Exchange*

The shortage of foreign exchange, like at GMK, was reported to cause production bottlenecks for AVA. Franchise holders were unable to get access to sufficient foreign exchange to utilise their capacity quota at AVA.

### *Volume levels*

The small volumes were reported to lead to higher costs of production for the supplier. In addition, lack of standardisation of components means that they are not interchangeable, and hence have to change with every make or model. Like GMK, managers at AVA felt that this mean unnecessarily higher prices charged by local suppliers.

### *Costs of materials*

Like GMK, AVA has cost related problems with local suppliers which lead to frequent price increases. One of the reasons hypothesised by AVA for this increase is the high cost of obtaining both local and imported materials for the manufacture of parts and components. However, according to one manager, some suppliers do not have cause to raise prices as often and as high as they do. He remarked

some suppliers are simply opportunistic - they raise prices at the slightest excuse simply because they know there is nothing we can do about it.

AVA, like GMK, has opted for multiple sourcing in order to reduce this vulnerability. However, in some cases, such as the case of tyres and tubes, there is no alternative supplier.

### *Single Vs multiple sourcing*

This refers to the measures that AVA has taken to reduce dependency on one supplier, and any subsequent loss of bargaining power. Discussing the rationale for multiple sourcing AVA's MD saw it as a reasonable and rational strategy in an environment where suppliers, pressured by a harsh economic environment, are likely to become opportunistic. He added that uncertainties in the economy encourage businessmen to utilise any opportunities to the maximum: "sometimes this means charging the highest price possible". It was also clear that AVA's management was aware that multiple sourcing made suppliers uncertain about future orders, but this was argued to have the effect of making them more 'willing' to be flexible. AVA tends to distribute her requirements equally among suppliers as an assurance against work stoppage rather than as a price bargaining tool.

### *Organisational policy and strategy*

AVA is a Kenyan company, and therefore unlike GMK, did not report a global corporate (headquarters) policy and strategy specifications to outsource or develop local suppliers. Besides, the number of items directly sourced by AVA is small (see *Table 7-9*) and may not warrant specific organisational policies towards sourcing. Consequently, because choice is restricted by legislation and mandating of local sourcing of some items, AVA's strategy is to source locally whatever is mandated.

## BUYER - SUPPLIER RELATIONS

Buyer-supplier relations at AVA are subsumed under the relations between the importers and their suppliers, except on those items sourced directly by AVA. Consequently, the discussion presented here relates only to those items directly outsourced by AVA.

## SUPPLIER DEVELOPMENT ACTIVITIES

AVA did not report any supplier development activities. Again, this can be attributed to the assembler-importer arrangements where the purchasing decision is taken away from the assembler. The only level of supplier development could be assumed in the manufacturer's specifications given to the supplier for the components and parts which AVA buys-in. In this respect, some technology transfer takes place. However, in the case of AVA where only paints and paint shop chemicals are purchased directly, there are few opportunities for supplier development, except in the form of technology transfer through specifications to the supplier. In any case, the suppliers of paints and chemicals (*Table 7-9* above) are companies generally regarded as large to medium sized firms, with some access to resources for their own development.

## CONTRACTING

As already noted, there are no specific contracts between AVA and her suppliers. Instead, there are 'agreements' in the form of orders or intended orders by the buyer, communicated in letters or Purchase Orders. The MD reported that AVA enters into communication with its suppliers in order to ensure that the specifications and compositions of the ordered items match the importer's specifications. For example, in the case of paints and Paintshop chemicals, AVA is in constant touch with the suppliers during the formulation stage of a batch of paints. Samples are analysed and tested by AVA until the production engineers are satisfied with its quality. There is also an unwritten agreement that in the unlikely event that AVA is not happy with any of the products, arrangements would be made to rectify this. According to the production manager, all the suppliers try to ensure that there are as few complaints about quality as possible - "we have traded with them since 1977. They cannot afford to let us down!" However, in cases where items are bought routinely on order only, such as in the cases of oils and lubricants, AVA simply give the supplier their quantity specifications, and the suppliers deliver whatever items have been ordered. There are, therefore, minimal contacts between the purchasing department at AVA and the supplier's sales department except in cases where goods do not meet specifications.

AVA also buys in 70-80% of its service requirements (i.e. laundry, advertising, and legal services) except for a small proportion of security services (security guards) estimated to be 30-40% of the

security requirements. The rest comes in the form of hardware such as alarm systems, which are often imported.

As at the time of the fieldwork, AVA proposed to start the manufacture of shock-absorbers to cover its own needs for the various ranges of makes and models, and also for export. At the time, all shock-absorbers were bought in from Hill Products, a medium sized Kenyan firm, who are still the sole producers of shock-absorbers in Kenya. For this reason, AVA contractors have had problems with this supplier, ranging from frequent price increases to availability. This discontent with the performance of single suppliers is a recurrent theme in the problems reported by all the companies interviewed, and reinforces the buyer's justification for multiple sourcing..

### **ORGANISATION OF PURCHASING ACTIVITIES**

The bulk of AVA's purchasing activities is organised around the importers/franchise holders. This section discusses only those activities which AVA purchases directly (see *Table 7-9* above). For these direct purchases, it is only in the case of paints and Paintshop chemicals that AVA has had prolonged interactions with the supplier. The final product is the outcome of a negotiation process where specifications are given to the supplier and continual adjustments made until there is consensus on the quality of the product. For the fairly standard items such as oils, lubricants, welding materials, and adhesive materials, a routine order is placed for a particular quantity and no further interaction takes place until the next order. Hence, products requiring particular specifications necessitate frequent interaction between the buyer and supplier, at least for the duration of the order, while standardised products do not.

#### ***Transactional dependence***

Another dimension of buyer-supplier relations is transactional dependence, and related bargaining power considerations. In order to reduce dependence on any one supplier, AVA has a policy of multiple sourcing. In turn, its suppliers have multiple customers. This strategy reinforces the arms-length relationship with its suppliers.

#### ***Trading patterns***

As noted above, the trading patterns between AVA and her suppliers are of a 'short-term' nature, usually lasting the duration of the order until the next lot is required. Even in the case of paint procurement, the exchange of information is limited to the duration of the order unless subsequent orders carry the same specifications as previous orders, in which case, the knowledge gained in these previous relationships is used in the new order.



### *Quality issues*

The question of quality was brought up in all of the three interviews with AVA managers and is a constant point of contention between suppliers-assemblers and franchise holders. The whole process of quality control is shared between AVA and her contractors. However, the production manager at AVA was keen to remark that since the total quality of the vehicle was ultimately the responsibility of those who put it together (in this case the assembler), it is critical that they get the quality of the inputs right. For this reason, AVA has rigorous quality control procedures when materials are received at the plant. Together with a quality officer from the importer's firms, production engineers at AVA check the quality of the materials delivered by suppliers against manufacturer's specifications. Discrepancies are reported to both the supplier and the importer. Apart from potential delays in the production schedule, AVA does not bear any of the costs of reworking or replacement of items. This is negotiated between the supplier and the importer.

It was also found that the manufacturers provide continuous technical guidance and training to AVA staff as a strategy for achieving the quality standards they have set, the cost of which is borne by the franchise holder. Obviously this cost is eventually transferred to the customer. AVA has its own in-house technical improvement programme aimed at improving efficiency and testing new approaches to manufacture or adaptation of process, parts and components to Kenyan requirements. To this end, in 1987 AVA commissioned a technical development programme implemented through AVA Sport, and has since collaborated with Ford Motors on their Sierra Cosworth car. Lessons learned in this exercise have since been implemented throughout the plant, particularly in workmanship standards.

### *Communication with suppliers*

The study also sought to establish the nature of communication and information exchange between AVA and its suppliers as an indicator of buyer-supplier relations. Thus related to the issue of trading patterns, the extent to which buyers communicate with suppliers, and the extent to which information is 'shared' between them were important. As noted in chapter four, it is argued that the extent to which firms share information is indicative of the nature of supplier relations - little information sharing between buyer and seller designates relations as ACR, hence reduces the frequency of inter-firm transactions, while greater information sharing designates relations as more OCR. It was reported that only that information pertinent to the order, and necessary to meet the manufacturer's specifications was exchanged between AVA and its suppliers.

## **BUYER PERCEPTIONS OF SMES AND BUYER PREFERENCES OF SUPPLIER CHARACTERISTICS**

This study also sought to establish the extent to which large firms (assemblers and importers) were willing and able to transact with small firms. It was evident that AVA is more concerned about meeting its requirements (reliability, availability, cost and quality) rather than concerned about the characteristics of the supplier *per se*. However, the production manager conceded that although they do not buy many of the items directly, they have had problems with the quality of items delivered (on behalf of the importers) to the plant. Although this was not stated explicitly, it was implied that larger firms are more reliable with respect to quality, prices and availability of components.

AVA managers did not express any specific preference for a particular size or type of supplier so long as the products met their cost, quality, availability and reliability requirements.

## **FORMING INTER-FIRM LINKAGES WITH SME SUPPLIERS**

In order to establish the attitude of AVA towards inter-firm linkages, particularly with small firms, respondents were asked to indicate their opinion about small and medium firms as partners or suppliers. The Managing Director noted that as far as AVA is concerned, what matters is the quality which a firm can deliver regardless of size. However, he conceded that given the prevailing low level of technology in many small firms in Kenya, they are likely to offer lower levels of quality than larger, more established firms. He also conceded that in some cases, buyers have little option - some components' sectors have predominately small to medium firms. Giving the example of radiator companies, he noted that almost all firms in this sector employ fewer than fifty people, thus falling in the category of small to medium firms. All buyers in the motor vehicle industry are, therefore, compelled to buy from these manufacturers.

It was also clear from the research that AVA's concern is to maintain a continuous flow of inputs to avoid disruptions to the production process. It is argued by the MD, therefore, that if small firms are not able to meet volume requirements in addition to particular quality standards, AVA management are left with no option but to source from larger firms. In effect, whether AVA uses small or large firms largely depends on the ability of the small firms to meet its (AVA's) quality and volume requirements. Interestingly, there was no mention, during the interviews, of cost differentials between large and small firms.

In summary, AVA is part of a vertically integrated system of production. The research also reveals that it has local limited procurement potential since its contractors control the input procurement function except for a limited number of items agreed upon. The research found that the only reason

these items are sourced locally is because they are mandated by legislation. The main reason given for this limited local sourcing is the limited supplier base. However, AVA has not specific programme to develop its suppliers.

## **II MARSHALLS (EA) LTD.**

### **BACKGROUND**

Marshalls (EA) Ltd. is one of the thirteen franchise holders in Kenya's motor vehicle industry, having held the Peugeot franchise in Kenya for over 45 years. It became involved in the assembly business through part ownership (24.5%) of the AVA assembly plant. This discussion will focus on the sourcing behaviour and buyer-supplier relations.

### **FORMATION AND OWNERSHIP**

Marshalls Group comprises Marshalls (EA) Ltd. which holds the Peugeot, Volvo earth moving equipment and Tata trucks franchises; Doughty Ltd. which holds the Honda franchise; Lucas CAV; Bendix Ltd., producing bearings and allied products; Delta Ltd. which supplies Marshalls' requirements for vehicle batteries and shock absorbers, and also serves the replacement market; and Fulmen Batteries producing motor vehicle batteries. However, the Peugeot franchise is the group's flag bearer.

### **PRODUCTS AND PERFORMANCE**

Marshalls' Peugeot franchise is perhaps the most 'lucrative' in the Kenyan market with the Peugeot 404 having the status of the "best selling vehicle ever"<sup>56</sup>. Peugeot cars have long been associated with reliability and cost effectiveness since the first vehicles were imported into Kenya after the second world war. Currently, Marshalls offers a range of Peugeot and other vehicles, and also motor bicycles and power products through Doughty Ltd.

All of Marshalls (EA) products are assembled by AVA (see section I of this case study) in which Marshalls (EA) has a 25.6% share holding. Together with Toyota Kenya Ltd. Marshalls products constitute almost 70% of AVA's production.

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## PRODUCTION ORGANISATION

### PRODUCTION ORGANISATION ACTIVITY

Marshalls, unlike GMK and AVA, is an intermediate organisation without assembly facilities of its own (**Fig. 7-3**). Instead once the CKD kits have been purchased, Marshalls contracts AVA to assemble them. Marshalls then markets the vehicles. As noted in Section I above, Marshalls as an importer makes all the vital decisions about the importation of CKDs, and acquires other inputs locally.

*Table 7-10 Marshalls Product Range and Market Share (1992)*

Type	Market Share (in compatible market) (%)	Market Share of Segment Leader (%)
1. 205 Saloon	23.4%	56.3%
2. 504 Saloon	72.1%	72.1%
3. 405 Saloon	20.0%	72.1%
4. 504 Estate	64.6%	64.6%
5. 504 P/up Petrol	25.6%	28.4%
6. 504 P/up Diesel	5.6%	45.5%
7. Honda Civic	5.0%	32%
8. Tata Trucks (15 tons)	9%	35%
9. Tata Trucks (Ten tons)	11%	28%
10. Volvo Prime Movers	36%	50%

*Source:* Field Notes 1992/1993

### Production Activity Flows

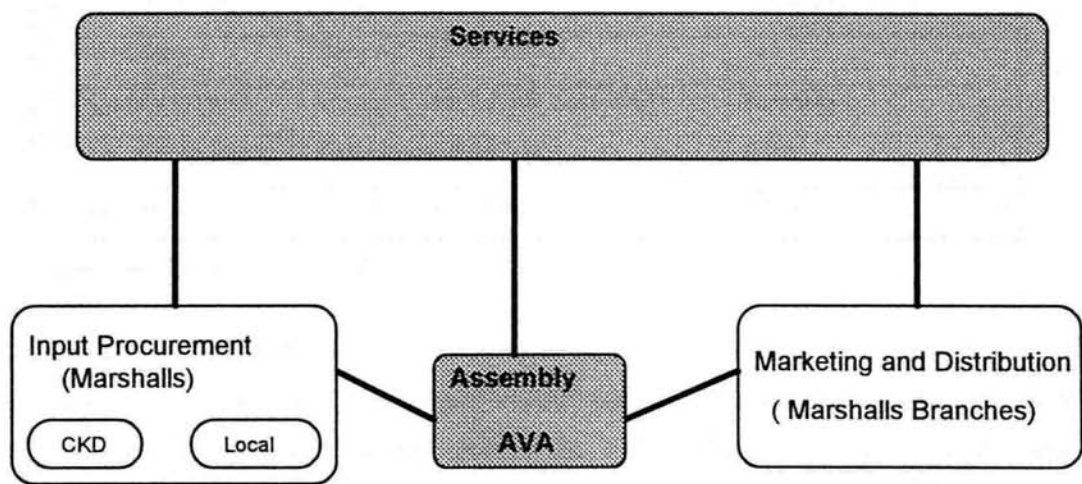
As can be noted from *Fig. 7-5* the activity flows show a different pattern from that of GMK and AVA. Although Marshalls has a share holding interest in the assembler, the input procurement, assembly, and distribution activities are separated.



**SOURCING ACTIVITY**

**SOURCING BEHAVIOUR**

Marshalls outsources its requirements from three main sources. Approximately 60% comes in as a CKD kit; foreign manufacturers of components supply about 15%; its local sister companies supply about 15%; while local independent suppliers supply about 10%. Like other assemblers and franchise holders, the bulk of this comes in the form of CKD kits. *Table 7-11* indicates outsourced items and their suppliers.



**Fig 7-5 Activity Flows - Marshalls (EA) Ltd.**

**Table 7-11      Marshalls - Outsourced Inputs and Suppliers (1992)**

<b>Item</b>	<b>Supplier (Size)</b>	<b>Ownership Link with Marshalls</b>
1. CKD kits	Automobiles Peugeot (AP)	Principals
2. Tyres and Tubes	Firestone (Large monopoly)	None
3. Batteries	Delta (Medium)	Marshalls Group
4. Glass	Impala Glass (Large monopoly)	None
5. Fuels	Esso Petrol Stations (Large)	Marshalls Dealer
6. Wiring Harnesses	Autosprings Ltd. (Medium)	None
7. Radiators	African Radiators (Small-Medium)	Marshalls Group
8. Shock Absorbers	Delta Ltd. (Medium)	Marshalls Group
9. Advertising	Scan Ad Ltd. (Medium)	None
10. Quality Control	Quality Control Audit Team (AP)	Principal
11. Security services	Kali Guards (Medium)	None
12. Laundry	White Rose (Medium)	None

*Source: Field Notes (1992/1993)*

Unlike GMK and AVA, Marshalls appears to retain one supplier for most items. As can be noted from *Table 7-11* four of the 12 items are sourced from Marshalls' sister companies through internal transfers. The MD saw this as a prudent move since Marshalls needs to support sister companies within the group for the benefit of the company. However, such internal transfers do not mean that Marshalls is not concerned about competitiveness. According to the Managing Director, all sister companies compete with other producers, particularly in the replacement market, hence they are viewed by management to be competitive.

Like GMK and AVA, Marshalls outsources only those items listed in the legal notices.

#### **MOTIVATIONS FOR SOURCING BEHAVIOUR**

The main motivation for outsourcing by Marshalls is the lack of capacity to produce its own inputs and can, therefore, be associated with necessity. Secondly, Marshalls managers reported that because of the Legal Notice requirements, they have had to procure inputs from local firms rather than have the CKD kit supplied complete.

## FACTORS INFLUENCING SOURCING BEHAVIOUR

It is noted above that sourcing activity outside the mandated items is minimal. As with AVA, managers at Marshalls reported that one reason for sourcing some of these items locally is compliance with government regulations as this meant that access to foreign exchange could be guaranteed in the future. In addition, since Marshalls is essentially a 'distributor', it lacks the capacity to produce in-house. Hence, its managers consider backward vertical integration to be a rational decision. The MD remarked that as a distributor, Marshalls would be vulnerable if it did not have a stake in the assembly and components sectors. He further argued that vulnerability arose from the fact that "you would never know when you are going to be hit!", presumably by suppliers [or assembler] not delivering for a variety of reasons. In essence, Marshalls has integrated vertically as an assurance against opportunistic behaviour by suppliers, in addition to work stoppage caused by 'genuine' problems.

Several specific factors emerge from the interviews with Marshalls managers.

### *Quality of local products*

Like GMK and AVA, Marshalls' concern with the quality of its final products makes this its primary concern in reaching decisions about sourcing - about the supplier, and whether to source locally or from abroad. According to one Marshalls manager, this objective has motivated the company to engage in its own production of vital components such as shock absorbers. Two factors were mentioned as important in this decision: due to poor technology, local suppliers cannot meet the high standards demanded by Marshalls' franchisors; many of the potential suppliers are small or medium companies which would not singly provide all of Marshalls' requirements. Although in-house manufacture of batteries was motivated by profits to be gained from the 'replacement' market, Fulmen batteries are quickly beginning to be considered one of the quality benchmarks for Marshalls products. Clearly, Marshalls obtains most items as part of the CKD kit, and those sourced locally are sourced within the group of companies.

### *Frequency of engineering and model changes*

Like GMK, Marshalls managers viewed the effect of frequent changes of makes and models as a limitation to the extent to which local suppliers can meet its (Marshalls') quality and delivery expectations. Marshalls managers consider the deletion of parts and components from the CKD kit a "waste of time" in the prevailing circumstances (principal suppliers are not willing to make significant deductions from the cost of the kit).

It was also argued by one manager that because suppliers have to deal with such frequent changes, their ability to 'specialise' is limited, thus undermining quality levels.

### *Access to foreign exchange*

Like GMK and AVA, access to foreign exchange was reported to introduce uncertainty into the company's supply chain. Because of limitations of foreign exchange, sister companies supplying Marshalls have had difficulties in filling their orders. It was estimated that the sister companies which supply Marshalls on average use about 60% imported materials. Hence, "given the choice", remarked one manager, "we would rather buy a complete kit. At least we are allocated foreign exchange to buy CKDs albeit on a rather uncertain basis, but the smaller suppliers have no way of accessing it".

### *Cost of materials*

Like GMK and AVA, Marshalls reported the frequently escalating cost of inputs sourced locally, particularly from those suppliers outside the Marshalls group. For example, a manager estimated that the cost of tyres and tubes had gone up by about 30-40% between 1991 and 1992. Although much of these price increases could be attributed, partly, to the declining strength of the Kenya Shilling, Marshalls perceived some elements of increases in various suppliers as 'opportunistic'.

It was also clear that because Marshalls does not have a specific multiple sourcing policy (unlike GMK and AVA), the retention of single suppliers contributed to this concern about frequent increases of the costs of local inputs.

### *Organisational policy and strategy*

Unlike GMK, and like AVA, Marshalls does not have a specific policy to develop local suppliers. Besides, given that Marshalls is part of a group of companies, it is in its interests to integrate both vertically and horizontally within the group in order to retain markets and to access resources.

## **BUYER-SUPPLIER RELATIONS**

### **SUPPLIER DEVELOPMENT ACTIVITY**

Unlike GMK, Marshalls does not have a supplier development programme. Suppliers of products not supplied by sister companies, are appointed and retained for the duration of the order, but the practice has been to retain suppliers for repeat orders even though there is no guarantee for future orders.

Like GMK and AVA, Marshalls provides suppliers with manufacturer's specifications for all its vehicles. In this respect there is some technology transfer. The principal suppliers also provide training teams to assist the assembler, and Marshalls has a Quality Control officer stationed in the assembler's plant. However, with regard to suppliers outside the Marshalls Group, there was no evidence of technical assistance and training from Marshalls. A probable explanation for this is that Marshalls do not have the engineering capability to provide such assistance.

### *Contracts*

No contracts are made between Marshalls and its suppliers outside the group. An order is made when components are required in the production chain (usually with a lead-time of two weeks to one month depending on the component type and quantities required). Given that many of Marshalls' suppliers are sister companies, there is constant communication between them, and Marshalls orders have priority status.

### *Transaction dependence*

Managers at Marshalls estimate that their suppliers have an average dependency rate of upto 40% on the new vehicle market while the replacement market takes 60%. On the other hand, because Marshalls has no production facility of its own, it completely depends on its suppliers. As already stated, Marshalls locally sources approximately 25% of its requirements (15% from sister companies and about 10% from independent local suppliers). However, because it retains one supplier in most cases, it is dependent it has a high dependency on its suppliers. In at least two cases (tyres and tubes, and glass), the dependence was reported to be 100% because of the monopoly status of the supplier of those particular products.

### *Trading patterns*

Like in the case of AVA and unlike GMK, trading patterns between Marshalls and its independent (not belonging to the Marshalls Group) suppliers are of a short-term nature, usually lasting the duration of the order. According to Sako's typology this denotes a more ACR than OCR relationship. There was little evidence of more exchange of information other than that contained in the specifications.

### *Quality issues*

Quality control is perhaps the most important concern at Marshalls. Apart from the quality assurance by AVA (the assembler), Marshalls have their own Quality Control officer at the assembly plant. It was noted in the discussion regarding AVA that the ultimate responsibility lies with the franchise holder and marketer of the vehicle - in this case, Marshalls.



### *Communication with suppliers*

Because of its co-ordinative role in the chain, Marshalls has frequent communication with suppliers, usually to check on the progress of production. However, only information relating to a particular order is exchanged between the companies. Because it is often necessary for Marshalls officers to know why orders have been delayed or why quality is not upto par, more information was given by the supplier than by Marshalls. For example when an order for wiring harnesses was delayed, Marshalls managers telephoned the supplier seeking an explanation for the delay, and how the suppliers' management were dealing with the problem. In the process, considerable amounts of information was released to Marshalls. Marshalls managers did not feel under obligation to offer any information outside that relating to how this delay was affecting the production chain.

### **FORMING INTER-FIRM RELATIONSHIPS WITH SMALL FIRMS**

This study intended to examine the willingness and propensity of firms to form inter-firm relationships, particularly with small firms. The concept of inter-firm relations refers to the extent to which the firm (or establishment) uses relationships rather than its own installations to provide its requirements. This includes sub-contracting relationships, joint ventures, and others. In response to a question about buying from small firms, the MD at Marshalls noted that while in principal Marshalls has no objection to trading with small firms, they (such small firms) do not meet the quality and reliability standards demanded by Marshalls. He further argued that when dealing with small firms, their low technological and managerial capabilities render the outcome of their general standards relatively lower than internally expected. In this respect, large and medium firms are still very much the most rational option for Marshalls - "unless, of course, one can make investments in in-house production" (MD), which is the option that Marshalls has taken in six cases of components' supply. However, he conceded that future company decisions could shift sourcing activity towards smaller firms.

### **BUYER PERCEPTIONS OF SME SUPPLIERS**

#### **BUYER PREFERENCES ABOUT SUPPLIERS**

Managers at Marshalls indicated that they prefer to contract with large and medium businesses, and usually do so. However, in some cases, usually where there are few alternative supplier firms to choose from, they contract with smaller firms. The reasons given for preferring large and medium firms include the following. (i) Large firms are better equipped to provide the quality of products Marshalls needs; (ii) buying from large firms means that they can deal with large

volumes, and are, therefore, likely to supply the quantity demanded; (iii) large firms are more likely to charge lower prices if they produce high enough volumes to yield lower unit costs.

However, it was also reported that Marshalls is beginning to seek out smaller suppliers because they are more likely to be more flexible than the larger companies, and can accommodate changes in schedules, prices and specifications more readily. According to the MD, it is also becoming apparent that smaller firms in Kenya are more innovative as they are not restricted by installation of 'specialised' machinery, and many years of ingrained production practices. They are, therefore, more likely to provide for Marshalls' need in the future. Another reason given for possible consideration of small firms is that Marshalls managers feel that when buying from small firms in Kenya, the larger buyer has more bargaining power over the smaller firm and for this reason will prefer to deal with this size of firm. The deciding factor in this case is the dependency of the supplier on the buyer. However, other factors are important in this decision. For example, managers believe that the small firm has to have the technological and managerial capability to meet the quality standards required by such a buyer.

### III TOYOTA KENYA LTD.

#### BACKGROUND

##### FORMATION AND OWNERSHIP

Toyota Kenya Ltd. (Toyota) is considered the flagship of the Motor Mart Group, a holding company incorporated in Kenya to deal with motor vehicle distribution and engineering. Motor Mart is a subsidiary of Lonhro East Africa Ltd. In 1992, it accounted for about 50% of all the Motor Mart Group's businesses, and in 1990, the Toyota make of vehicle had the largest market share in the industry (19%). The other divisions in the group include Kenya Motors, who hold the FIAT franchise; Bruce Trucks and Equipment, who handle the heavy commercial vehicles and equipment, including the Mitsubishi Fuso Trucks franchise; Yamaha Motors, who hold the Yamaha franchise in Kenya; Farm Machinery Distributors, who distribute Massey Ferguson tractors; and Burns and Blane Engineering, who manufacture radiators for the local market. This latter subsidiary supplies its sister companies with radiators for locally assembled vehicles, and spare parts for the replacement market for a variety of makes and models. The Motor Mart Group is the local holder of the largest number of franchises in Kenya. The group contracts AVA, in which it holds a 24.5% share, to assemble its vehicles.

##### PRODUCTS AND PERFORMANCE

Toyota vehicles are a popular make in the small saloon car segment in Kenya, but their market leadership is in the Pick-up Diesel model. *Table 7-12* shows the performance and market share of Toyota products in Kenya. Clearly, in the selected year, Toyota led the market in only one category of vehicles - the light commercial vehicle.

##### PRODUCTION ORGANISATION

As indicated above, Toyota is a motor vehicle dealer within the Motor Mart Group which has a variety of interests in the motor vehicle industry. Its main mandate is the marketing and distribution of Toyota products. Other sister companies within the same Group hold other franchises such as FIAT and Yamaha.

##### PRODUCTION ACTIVITY FLOWS

The production activity flows at Toyota are similar to those observed at Marshalls (see *Fig. 7-2*). Toyota buys CKDs from suppliers abroad (see the various franchises), and also buys local inputs. These are delivered directly to AVA in Mombasa for assembly. They are then transported to the

various Motor Mart Group distribution outlets in Nairobi, Mombasa, Nakuru, Kisumu and Eldoret (see Appendix G for location of towns on the map of Kenya).

**Table 7-12      Products and Market Share - Toyota Kenya Ltd. (1991)**

Vehicle Make	Market Share Toyota (%)	Market Share (Segment Mkt. Leader - %)
1. Toyota Sixteen	13%*	41%
2. Toyota Corolla 90	15%	32%
3. Toyota Corolla 90 Estate	14%	50%
4. Toyota Land Cruiser	1%	46%
5. Toyota Hilux DC	3%	46%
6. Toyota Hilux P/Up Petrol	18.4%	30.4%
7. Toyota Hilux P/Up Diesel	54.3%	54.3%
8. Hiace Mini bus	28%	69%
9. 3 ton DYNA	5%	44%
10. 7 ton Fuso Trucks	3%	63%
11. Ten ton Trucks	1%	29%

\* These figures are derived from sales in comparable market segments. For example, while the Fuso Trucks had a 3% and 1% market share in their segments, their combined share in the trucks sector was 39%.

*Source: Field Notes 1992/1993*

## SOURCING ACTIVITY

### SOURCING BEHAVIOUR

Toyota's sourcing behaviour is similar to that observed at Marshalls. First, there is a high level of interaction with sister companies, particularly Burns and Blane Ltd., a Kenyan medium sized subsidiary of the Motor Mart Group, which supplies all of Toyota's radiator requirements. Secondly, Toyota retains one supplier for most of its inputs. Finally, many of its suppliers also supply other franchise holders. However, this does not imply that there is an explicit agreement to use the same sources. *Table 7-13* below shows the outsourced inputs.

**Table 7-13      Outsourced Items and Suppliers - Toyota (1992)**

Item	Supplier (and size)	% of Requirements
1. Tyres and Tubes	Firestone Ltd. (Large monopoly)	100%
2. Batteries	Delta (Medium)	100%
3. Seats	Megh Cushions (also Silentnight since 1992) (Large)	90-100%
4. Soft trims	Megh Cushions Ltd. (discontinued Silentnight Ltd) (Large)	90-95%
5. Radiators	Burns and Blane (Medium)	100%
6. Windscreen and door glass	Impala Glass Industries Ltd. (Large monopoly)	80%
7. Spark Plugs	Car and General (sole producers in Kenya)	100%
8. Wiring Harnesses	Autospring Manufg. Ltd. (Medium)	80%
9. Leaf Springs	Autospring Manufg. Ltd. (Medium)	70-80%
10. Jacks	Autospring Manufg. Ltd. (Medium)	100%
11. Shackle pins	Autospring Manufg. Ltd. (Medium)	100%
12. Brake pads	1. Varsani Brakelinings (Small/medium) 2. R B Shaw (Medium) (used only occasionally)	60%} 90% 30%}
13. Airfilters	Autoparts (EA) (small/medium)	100%
14. Exhaust systems	Burns and Blane (Medium)	90-100%
15. Radio Cassettes	Stenerotte and Radio (Medium)	90%
16. Rubber Bushes and foam Strips	Rubber Products (Small) Foam Plastics (Medium)	}70-80% }
17. Speedometer cables	Express Morpets (Small/medium)	90%
18. Tool kit items	Venus Industries (Medium)	100%
19. Jack handle extension	Autospring Manufg. (Medium)	100%
20. Radiator Brackets and Inserts	Autospring Manufg. (Medium)	90%
21. Battery tray	Fibreglass and General Ltd. (Medium)	100%
22. Shock Absorbers	Hill Products (Medium)	100%
23. Spare wheel carrier and brackets	AVA (Large)	100%
24. Assembly	AVA (Large)	80%
25. Oils, greases and fuels	-	100%

*Source: Field Notes (1992/1993)*

Like the preceding cases, Toyota outsources only those products listed in the Legal Notices. It is also evident that Toyota retains one supplier in most cases, but has alternative suppliers whom they use from time to time, particularly when their main supplier has difficulties delivering. One of the reasons for this is that having one main supplier reassures the buyer of dedicated service from that supplier. Having said that, Toyota has alternative suppliers, "just in case", suggesting an inherent uncertainty about the reliability of any one supplier. The same manager remarked that volumes required by Toyota make it "senseless" to have more than one main supplier



"it simply adds to the final costs of the vehicle. You have [to] order twice. Then you have to co-ordinate the delivery to AVA from two or several other companies. Then you have to prepare payment documents to several companies. With the volumes we have, it is just not worth it!"

Currently Toyota have a total of 24 suppliers (including the assembler, AVA). In addition, almost all of the services (including transport, laundry, catering, distribution, and advertising) are provided in-house or by the holding company (which outsources about 30% of its services), and other sister companies. Consequently, one manager estimated that about 10-20% of service requirements are bought in, but this tends to be from large, established companies rather than from small firms.

### **MOTIVATIONS FOR SOURCING BEHAVIOUR**

As in the cases of GMK, AVA, and Marshalls, a manager explained that the most important factor motivating Toyota's sourcing behaviour (outsourcing) is the legal requirement to outsource certain items from the local market. However, it was evident from the interviews that like other franchise holders, Toyota would rather procure complete CKD kits from their principals. It was argued that the local suppliers do not meet the quality and reliability standards expected by Toyota manufacturers. According to one manager interviewed

"it was in this light that we considered producing our own radiators. This way, we can assure the quality of our vehicles. In turn, we avoid those expensive warranty costs caused by poor quality products from local suppliers".

Hence, it appears that the motivations for outsourcing are related to the factors inhibiting local sourcing. These are mainly related to the quality of suppliers and their ability to deliver Toyota's requirements in the expected 'state'. More specifically, the factors outlined below were stated as influencing the sourcing behaviour at Toyota. Evidently, these factors are similar to those stated in preceding cases.

### **FACTORS INFLUENCING SOURCING BEHAVIOUR**

The following factors were cited by Toyota managers as influencing their sourcing behaviour, in this case, a predominately outsourcing behaviour with a preference for procuring all inputs as part of the CKD kit.

### *Availability of Suppliers*

It was argued that because the Kenyan industrial sector is still relatively undeveloped, it is difficult to find suppliers for most products. A remark from one of the managers succinctly paints the scenario:

"Toyota literally has no option in some sub-sectors. There are just no suppliers. Take for example the case of wiring harnesses. There are perhaps only one or two producers in this country. Autospring Manufacturing Ltd. are a virtual monopoly in this sector. How do you make choices to buy locally, or even from small suppliers when they do not exist!

This factor was closely linked to the issue of quality discussed in the next section.

### *Quality of Suppliers*

Toyota's managers expressed their concern about the quality of local suppliers, arguing that because of low technological and managerial competence, many suppliers are unable to supply the quality of products required by Toyota manufacturers. In addition, local suppliers often use obsolete methods of production, with poor quality control procedures. As a result, Toyota would prefer not to take chances with the quality of its final products. This coincides with the arguments cited by GMK, AVA, and Marshalls presented in preceding sections. It was further argued that it is these general weaknesses in the capacities of local suppliers which make it imperative for Toyota to consider sourcing from foreign sources. One manager remarked, "if we could assure ourselves that local suppliers can meet our quality requirements, we would source most inputs locally".

### *Frequency of Engineering and Model Changes*

Like GMK, AVA, and Marshalls, Toyota cited the problems of frequent model changes as hampering the ability of local suppliers to become specialised enough to match the quality required by Toyota manufacturers. As argued by one manager, this is complicated by the fact that local suppliers tend to procure equipment from second-hand markets abroad with little assessment of the needs of the local market. As a result, when makes and models change, the new (and more challenging) engineering requirements become too challenging for them (small, local suppliers).

### *Access to Foreign Exchange*

Again, the lack of foreign exchange for the procurement of inputs for component manufacture was cited by Toyota managers. It was noted that the local components industry is heavily dependent on imported materials (estimated at 60-70%), some of which have import restrictions. Coupled with

the scarcity of foreign exchange at the time of the current study, this was seen as one of the reasons why local firms could not provide the quality and volume levels that assemblers needed.

Like GMK, Toyota managers reported that the fluctuations in the availability of foreign exchange, in addition to currency fluctuations, have introduced a high level of variability in component prices. It was noted that many inputs had increased in price by upto 30% between 1989 and 1990, and by about 40-50% between 1990-1991.

### *Volume Levels*

Another factor cited by Toyota is the ability of local suppliers to supply the volume required for the new vehicle (Original Equipment) and replacement markets. It was argued that many small suppliers are not able to meet the volume levels required by Toyota. Whereas the absolute numbers required for assembly activities is not very large (considering that for example, in 1991 6,600 passenger vehicles were assembled in Kenya), many of the components manufacturers supply several importers/franchise holders at the same time. In addition, these same producers supply the replacement market. Cumulatively, therefore, the volumes are far higher than can be handled by the suppliers.

On another level, the variety of makes and models which have different specifications, make it difficult for suppliers to 'build' adequate volumes for full production runs. Making an assessment of the situation, one manager noted that "when an order is given, the supplier tries to fill that order. Many times, there's no question of efficient production runs. What matters to the supplier is to fill the order!" Consequently, he added, production is not efficient, and accruing costs are ultimately transferred to the customer.

### *Cost of local inputs*

As in the cases of AVA, GMK and Marshalls, the cost of local inputs was cited by Toyota as affecting the viability of local sources. It was argued that suppliers were suffering from double taxation in many cases. Because they use a considerable proportion of imported materials, they pay duties and taxes on materials. In addition, they often have to buy small quantities of local inputs and therefore often obtain them from retailers or wholesalers rather than from the manufacturer. In this way they are charged higher prices including VAT and other sales taxes paid on these materials. Given these high costs, it is more expensive for Toyota to procure inputs locally, hence the preference for importing as complete a CKD as they possibly can.

### *Deletion penalties*

Toyota managers also cited the problem of deletion penalties imposed by the franchisors when items are excluded from the CKD kit. It is argued by manufacturers that these penalties aim to reduce the extent to which the manufacturing process is disrupted through non-standard procedures such as removing items from a component or sub-assembly. On the other hand, many importers and governments in importing countries perceive this as a conspiracy to keep the importing countries dependent on the exporters, reducing the ability of importers to build their own manufacturing capacities for vehicles (Doner, 1993). Having said that, managers at Toyota noted that while deletion penalties have led them to source from foreign suppliers, the lead-time and foreign exchange problems involved in the importation of CKD kits make it economically prudent to source locally "if only the suppliers were available and could meet our needs".

### *Single sourcing*

As with AVA, GMK and Marshalls, Toyota managers cited the problem of single sourcing, particularly from monopoly suppliers, as posing an additional cost problem to the company. It was argued that Toyota, like all franchise holders, is not in a position to bargain with monopoly suppliers. In addition, as was noted above, Toyota adopts the policy of retaining one *main* supplier for each input although an alternative supplier is kept 'handy' with occasional orders. Because of a single sourcing policy, Toyota have few assurances against price increases or other opportunistic behaviour by suppliers.

### *Organisational Policy and Strategy*

Like AVA and Marshalls, and unlike GMK, Toyota has no specific policy to develop suppliers nor does it have a specified commitment to source locally. Being essentially a distributor, its aim is to make the most profitable business decisions. In this case, and under the prevailing circumstances, the decisions do not favour local sourcing, particularly from small components and service producers.

## **BUYER-SUPPLIER RELATIONS**

Based on Sako's typology, buyer-supplier relations between Toyota and her suppliers can be described as ACR. Toyota has no particular commitment to her suppliers, except perhaps, for Burns and Blane (which is a sister company). Even then, little is done by Toyota to develop it. This is done at group level, with engineering and technical assistance provided for the company. No parallel assistance is given to other suppliers. This can be attributed to the ACR relations between Toyota and her suppliers. The following factors describe the nature of these relations.

## **SUPPLIER DEVELOPMENT ACTIVITY**

Unlike GMK, and like AVA and Marshalls, Toyota does not have specific supplier development activities. There is neither a programme in place nor intended in the near future.

### *Contracting*

There were no written contracts between Toyota and her supplier, many of the inputs being produced on order only. Hence, there are no long-term contractual relations between Toyota and her suppliers. However, this lack of contracts does not imply that oral communication is used instead (as in OCR relations). A Local Purchase Order (LPO) is used to prompt production of a particular order. This coincides with the findings at GMK, AVA, and Marshalls.

### *Transaction Dependence*

Toyota depend on local suppliers for about 40% of their requirements, with the balance being imported. On the other hand, their suppliers generally supply other franchise holders, and also the replacement market.

### *Trading Patterns*

Except for their sister company, Burns and Blane, Toyota does not have long-term contracts with its suppliers, and no repeat orders are assured. In 1992 for example, Toyota changed its supplier for soft trims from Silentnight to Megh Cushions Ltd.. Reasons given for this shift included high prices, poor quality, poor production scheduling, lack of specialisation, and poor after-sales service. Clearly, any number of issues is capable of triggering a withdrawal by a buyer.

### *Quality issues*

Toyota's quality assurance procedures resemble those at AVA and Marshalls. Because the final quality of the product ultimately rests with the distributor (Toyota), quality control engineers 'follow' products from the supplier's factory, to the assembler's plant. Hence, quality inspection starts with the suppliers but is extended to the assembler's plant. However, the cost of defective components rests with the supplier.

### *Communication with Suppliers*



## **BUYER PERCEPTIONS OF SME SUPPLIERS**

### **CHARACTERISTICS OF SUPPLIERS**

*Table 7-13* shows that a large proportion of Toyota's suppliers are medium sized firms. Toyota managers view this as the result of a lack of 'good quality' small firms, and on the other hand, the avoidance of the components subsectors by large firms. Hence, outsourcing from medium firms arises as a compromise given the quality and availability of suppliers in the Kenyan economy.

### **PREFERRED CHARACTERISTICS OF SUPPLIERS**

As noted in the preceding paragraph, managers at Toyota would rather buy from large and medium enterprises. This finding was also reported for the AVA and Marshalls cases. In the case of GMK, while they accepted the ease of trading with larger firms, they perceived future productivity increases coming from relationships with smaller firms.

## **FORMING INTER-FIRM RELATIONSHIPS WITH SMALL FIRMS**

Inter-firm relationships with small firms are evident as they are at Marshalls only to the extent that there are no other suppliers within the sector. Toyota managers conceded that they prefer large and medium suppliers because of their ability to meet quality and volume requirements, and are generally "more reliable" than smaller suppliers.

Having said that, it was evident that given the monopoly status of many of the large suppliers in Kenya, which allows them considerable bargaining power, managers at Toyota are willing to procure from smaller firms. They argue that smaller firms are easier to 'manage' in the sense that they are more flexible, and more willing to meet the fluctuations in orders brought about by frequent changes in makes and models. However, this 'willingness to relate with small firms is currently made difficult by the perceived weaknesses of the small firms. This finding is similar to that found in the AVA and Marshalls cases.

## **SUMMARY AND CONCLUSION**

This case study has described the production and sourcing activities of AVA, and two of its main contractors (Marshalls (EA) Ltd. and Toyota (K) Ltd.). It has shown that the sourcing activities at AVA are limited to a few items they are 'allowed' by the Importer-Assembler agreement to source on behalf of importers. As a result, the bulk of the sourcing decisions are made by the importers/franchise holders. It also shows that the level of outsourcing is restricted to the items contained in the Local Notices. In addition, the franchise holders have found it necessary to invest

Generally, this model differs from the GMK model with respect to sourcing behaviour, and the nature of buyer-supplier relations. While GMK has supplier development programmes, AVA does not. This can be attributed to the 'commercial' orientation of the franchise holders who are the decision makers at AVA.

## **CASE THREE**

### **KENYA VEHICLE MANUFACTURERS LTD. (KVM)**

#### **INTRODUCTION AND BACKGROUND**

This case describes and analyses the activities of the third assembler in the Kenyan motor vehicle industry, Kenya Vehicle Manufacturers Ltd. (KVM). The presentation of this case is similar to the presentation adopted for AVA in the previous section because of similarities in production organisation. KVM is a contract assembler whose activities and decisions are tied to those of its franchise holders, hence two of these will be presented alongside it. DT Dobie Ltd. and Cooper Motor Corporation (CMC) are presented as embedded case studies. Together, these franchise holders constitute the largest proportion of KVM's activities.

The case will be divided into three parts, each presenting each case study (or embedded case study). In addition, the presentation will make comparisons with the AVA and GMK case studies where they coincide or differ in order to minimise detail.

## **I KENYA VEHICLE MANUFACTURERS LTD.**

### **BACKGROUND**

#### **FORMATION AND OWNERSHIP**

Kenya Vehicle Manufacturers was incorporated in July 1974 as Leyland Kenya Ltd., a subsidiary of British Leyland of Britain. Through a special resolution by shareholders, the company changed its name in May 1989 to its current name. Interestingly, KVM was the first vehicle assembly plant to be incorporated in Kenya. However, its assembly activities began at about the same time as the other assemblers, with its first production in August 1976.

In 1992, KVM's investment in buildings stood at K£4.7 million<sup>57</sup>, on land covering about 40 acres. At this time, installed capacity was 6,600 vehicles per annum with assembly being organised on contract basis. However, since inception KVM, like the other assemblers have not utilised their full capacity. This has continued to deteriorate in the face of competition from cheaper, imported completely built vehicles among other industry problems. For example, prior to the extreme industry problems in 1992 and 1993, KVM produced at 74% capacity on a one shift basis. By 1992, production had dropped to just over 30%.

KVM's ownership structure is similar to that reported for AVA. The Government of Kenya has been the majority shareholder since its establishment, and upto the time the study was undertaken (1992/1993), but plans were underway to divest from the motor vehicle industry. *Table 7-14* shows the equity distribution. It was evident that this share holding structure was reflected in the boardroom. It is CMC and DT Dobie who implicitly influence decisions related to various aspects at the KVM plant.

*Table 7-14      Ownership Structure -  
KVM (1992/1993)*

Kenya Government	35%
CMC Holdings Ltd.	32.5%
DT Dobie & Co. Ltd.	32.5%

## PRODUCTS AND PERFORMANCE

The plant was originally designed to produce light and heavy commercial vehicles including Land Rovers, Range Rovers, Volks Wagen micro-buses, Leyland trucks and buses. In 1986, KVM moved into passenger vehicle assembly together with other actors in the industry. In 1992, KVM was producing upto 47 different makes and models, reporting an average production of 3,000 vehicles in 1992, and approximately 2,000 vehicles in 1993. This low performance was attributed to the depressed local economy, but more to the scarcity of foreign exchange in Kenya. *Table 7-15* indicates the various franchises and types of vehicles assembled at KVM.

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<sup>57</sup>. One K£=KShs.20. The exchange rate of the Kenya Shilling to the Pound currently averages one hundred shillings.

**Table 7-15      Franchises and vehicle types - KVM (1992/1993)**

Franchise holder/distributor	Vehicle Type
Cooper Motor Corporation	1. Suzuki 580 2. Mitsubishi Pajero 3. Suzuki Jeep 4 WD 4. L 300 Pick-up 5. Land Rover 6. Leyland DAF trucks & Buses 7. Nissan trucks (7,8,9,14,15, and 45 tons) 8. 67 Seater buses
Hughes Ltd.	1. Mazda 323 (saloons and estates) 2. 4 ton trucks 3. B 1600 pick/up (1 ton) 4. 4 ton Cab T 1400
DT Dobie (K) Ltd.	1. Nissan Sunny 2. E-23 minibus 3. Datsun 1/2 ton pick-up 4. Sahara d-21 pick-up (4WD) 5. 3 ton Nissan trucks and buses 6. Mercedes trucks
Simba Colt Ltd.	1. Canter (434) 2. Double Wheel Volkswagen Kombi

*Source: Field Notes (1992/1993)*

## PRODUCTION ORGANISATION

Like AVA, KVM is organised around the assembly activity (see **fig. 7-3**). Other activities enter the assembly process at different levels. For example, materials come in from the franchise holders directly to the plant, while both in-house and outsourced services are also applied to it at this level. KVM buys-in security, insurance, laundry and about 50% of legal services. Transportation of CKDs and related inputs are the responsibility of the franchise holder.

## ORGANISATION OF PRODUCTION ACTIVITIES

KVM has 5 flexible production lines, with an average of six workstations on each line. Like the other assemblers already discussed, KVM managers argue that this flexibility is made necessary by the large number of makes and models being assembled at KVM.



## **PRODUCTION ACTIVITY FLOWS**

Production activity flows are similar to those of GMK and AVA. Similar to what occurs at AVA, CKDs arrive in a relatively 'complete' state, requiring few other inputs. They then enter the production line going through similar stages as identified in the case of AVA (Fig 7-4).

## **SOURCING BEHAVIOUR**

### **SOURCING ACTIVITY**

Due to its assembler status, KVM does not source CKDs which, as stated, are sourced by the importer/distributors. However, a small range of inputs ('consumables') are sourced by KVM.

Except paints, chemicals, and oils and fuels, all other inputs procured directly by KVM are not direct materials. This can be explained by the Importer-Assembler agreement which only allows KVM to purchase agreed inputs.

It is also evident from the table that like other players in the industry, KVM retains more than one supplier for most items, although they generally have a 'preferred' supplier for most items. This characteristic extends into the buyer-supplier relations with her suppliers. While there have been no overt 'unpleasant episodes' with her suppliers, KVM managers noted that they were aware that some suppliers are uneasy about this form of relationship.

An interesting and unexpected finding is that many of KVM's suppliers are small or medium enterprises. KVM managers provided two explanations for this phenomenon: (i) the nature of the inputs purchased from small or medium enterprises were required in small quantities and hence could not be procured from large firms. Consequently, because requirements have to be 'spread' over a number of suppliers, the quantities are only viable for smaller enterprises.; (ii) for about 70% of the items, only small suppliers exist, hence there's no option. However, like all other assemblers the main inputs were procured from medium or large firms. For example, paints were procured from the large paint manufacturers. The remaining items were procured from large monopolies (i.e. electricity, water, telephone services, etc.).

### **MOTIVATIONS FOR SOURCING BEHAVIOUR**

As noted above, for those items that KVM has jurisdiction to source, all of those sourced locally are those contained in the Legal Notices. No items outside this list are outsourced. Like in the case of AVA and her contractors, KVM is 'forced' to source locally by government regulation. It was also reported that KVM does not have the capacity to provide many of the inputs due to a lack of in-house capacity, particularly for services such as security, etc. An interesting finding regarding

services is that KVM originally had an internal security service but had decided to 'farm' it out, according to the Company Secretary, "to those whose primary business is to protect others". This argument is in addition to the perceived high cost of in-house capacity given that the low frequency of transactions does not warrant such investments.

The following factors were cited as influencing sourcing behaviour.

#### FACTORS INFLUENCING SOURCING BEHAVIOUR

Like AVA, KVM's sourcing behaviour is circumscribed by the Assembler-Importer agreement which allows the assembler to source only some items. The following factors relate to those inputs and services which KVM can source. As will be evident, many of these factors are similar to those cited by GMK, Marshalls, Toyota and AVA.

*Table 7-16 Outsourced items and suppliers - KVM (1991)*

Item	Source (Size of supplier)
Paints	1. Sadolins Paints (44%) 2. Twiga paints (48%) } Large 3. Berger paints (8%) }
Fuels and oils	1. Caltex (K) Ltd. (Large) 2. Brake Fluids (K) Ltd. (Medium)
Chemicals	1. Henkel (K) Ltd. (Large) 2. Diversy 3. Industrial Distributors
Consumables (includes cleaning and maintenance materials, rubber products, hand tools and equipment, industrial clothing, etc.)	1. Dunlop (K) Ltd. (Medium to large) 2. Protech Ltd. (Medium) 3. Henkel (Large) 4. Car and General Ltd. (Large) 5. Machinery Tools Ltd. (small-medium) 6. Alibhai Sheriff (Large merchant) 7. Koimu Ltd. (Small) 8. African Industries Ltd. (Small) 9. Techard Steam & Power Ltd. (Small) 10. Associated Alloys Ltd. (Small-medium)
Sanding Materials	1. Protech Ltd. (Medium) 2. Techard Steam & Power (Small)
Sealants and adhesives	1. Land Rover Exports
Security	1. Falcon Security (Medium) 2. Group 4 Security Ltd. (Medium) 3. Securicor Guards (K) Ltd (Large) 4. Security Guards Service Ltd. (Medium) 5. Factory Guards Ltd.
Telephone and Telex services	Kenya Posts and Telecom. Ltd. (Large state monopoly)
Electricity	Kenya Power & Lighting Co. Ltd. (Large state monopoly)
Water	Various local councils (Monopolies)
Insurance	MINET ICDC (Large)

*Source: Field Notes (1992/1993)*

### *Supplier availability*

KVM's main concern is with the unavailability of 'good quality' local suppliers. Managers at KVM attributed their reduced competitiveness to their inability to source locally owing to this paucity of local firms. According to one manager, this is even more so

"particularly [in the case of] small firms which would give us considerable savings on inputs. We do not import many inputs because we do not need to buy very much anyway!. If we were importers, I am sure we would be forced to import many items - they are just not available locally. Those that are, come a poor second to the imported counterparts."

This finding matches what has been reported in the preceding case studies. However, it must be noted that KVM have several small to medium suppliers on their books. According to the managers at KVM, there were no particular problems peculiar to these suppliers. They viewed supplier problems as generally similar.

### *Quality of local products*

Like the other assemblers, KVM's concern with the quality of the final product influences many of its sourcing activities. It was evident from the interviews that KVM managers perceived local suppliers to be unable to meet the quality standards set by the various manufacturers.

### *Frequency of engineering and model changes*

Like GMK and AVA, managers expressed concern about the frequency of engineering and model changes which prevent local suppliers from meeting the quality and volume requirements of buyers. This was, in turn, attributed to lack of specialisation in the face of such frequent changes.

### *Access to foreign exchange*

Like the cases discussed in preceding sections, access to foreign exchange was cited as influencing sourcing behaviour at KVM. This factor is linked to that of cost of local materials and services occasioned by a variety of reasons. Managers at KVM argued that foreign exchange restriction had not only made it difficult for importers to obtain CKD kits, but had also restricted the extent to which suppliers could supply their requirements reliably - explained to mean quality and cost expectations.

### *Cost of materials*

Like GMK, AVA, Marshalls and Toyota, KVM expressed preferences for inputs coming in as part of the CKD because of the escalating costs of local materials. Managers at KVM argued that the general weakness in the economy has made local inputs expensive relative to imported items.

In addition, KVM managers reported that in order to prevent excessive price hikes they have adopted a multiple supplier strategy for those items they perceive to have a potential for frequent price increases.

### *Organisational Policy and strategy*

Unlike GMK and like AVA, Marshalls and Toyota, KVM does not have an explicit policy to develop local suppliers, or indeed to buy from local suppliers. According to KVM managers, their main concern is to produce high quality goods which meet the quality expectations stipulated by the customers and their (KVM's) contractors, the franchise holders. Given this overriding concern, KVM's managers take those options that best satisfy this commitment. As noted by one manager

"Our first duty is to the customer. If quality means that we have to buy from abroad, then we shall do so. At the moment, it is more logical to buy from such [foreign]sources."

## **BUYER-SUPPLIER RELATIONS**

### **CONTRACTING**

Like in the preceding cases, there are no written contracts for long-term supply of items. Instead, an order form is used. In some cases, telephone conversations between a purchasing officer and a sales person at the suppliers office is deemed sufficient to initiate an order or delivery to the KVM plant.

### **ORGANISATION OF PURCHASING ACTIVITIES**

As already noted, orders are initiated either through a formal order or a less formal telephone conversation. However, when this happens, they are usually followed up by a written order. It was also clear that no assurances of long-term contracts are made.

### *Transaction Dependence*

hand, KVM managers estimated that their suppliers have an average dependency rate of about 20% since they supply most of the assemblers (or franchise holders).

### *Trading Patterns*

Like in the case of AVA, Marshalls and Toyota, trading patterns between KVM and its suppliers are of a short-term nature, usually lasting the duration of the order. According to Sako's typology, this denotes an ACR rather than an OCR relationship. In addition, there was little evidence of exchange of information between KVM and its suppliers other than the specifications pertaining to the orders. For example, when a supplier did not meet agreed quality and delivery requirements, KVM simply used another supplier - hence the retention of more than one supplier for most items.

### *Quality Issues*

As mentioned earlier, like other assemblers, quality control is perhaps the most important concern at KVM. It is therefore not surprising that KVM's managers are concerned about the fact that they cannot make decisions about most inputs which they consider vital to the final quality of the products.

### *Communication with Suppliers*

For those items KVM procures directly, communication with suppliers is related to a specific order only. For those items procured by the importer, the communication is between the importers and KVM and between the importers and the suppliers. KVM only communicates with suppliers to clarify or explain specifications.

### *Supplier Development Activities*

Like AVA, Marshalls and Toyota, KVM does not have specific supplier development activities. Relations can be described as essentially arms length - ACR.

## **BUYER PERCEPTIONS OF SME SUPPLIERS**

### **CHARACTERISTICS OF SUPPLIERS**

As shown in *Table 7-16* most of KVM's suppliers can be described as small or medium. Reasons provided for this status were similar to those provided by Marshalls (see case two).



### **PREFERRED CHARACTERISTICS OF SUPPLIERS**

While KVM has more small or medium suppliers than large ones, it was out of necessity rather than choice. According to one manager, for those products where they have more suppliers, few large firms operate in these sub-sectors. In addition, KVM managers argue that because of the small volumes they require for some of these items, few large firms will handle them. This finding was intriguing because while this argument was put forward for buying from smaller firms, orders were split up among several such suppliers, partly as an assurance against failure to deliver, and partly in order to realise KVM's volume requirements. One example evident in *Table 7-16* regards security services.

### **FORMING INTER-FIRM LINKAGES WITH SMALL FIRMS**

In order to establish whether assemblers and franchise holders are willing and able to form linkages with other firms, particularly with small firms, they were asked to what extent they would use small firms as suppliers. As has been evident in the preceding discussions, KVM has used some small and medium firms. However, it was clear that this was out of necessity than choice. First, while KVM managers have no objections to buying from small firms, it was clear that they were concerned about the quality and reliability of local producers.

## II DT DOBIE

### BACKGROUND

DT Dobie is one of KVM's shareholders and contractors.

### FORMATION AND OWNERSHIP

DT Dobie is a private company incorporated in Kenya. Details of its formation and ownership were withheld for reasons of confidentiality.

### PRODUCTS AND PERFORMANCE

DT Dobie hold the Nissan (Japan) and Mercedes (Germany) franchises in Kenya. Nissan vehicles are assembled by KVM, while Mercedes vehicles have been imported as completely built vehicles since the 1960s. In 1991 and 1992, several of DT Dobie's products held market leadership in their respective segments. One of the explanations given by various observers and participants in the industry is that partly due to prudent commercial decisions in 1991, DT Dobie had CKDs for assembly when the rest of the industry were experiencing extreme shortages. Consequently, DT Dobie reported steady sales when other franchise holders had suspended importation of CKDs due to a shortage of foreign exchange.

In 1991 and 1992, Nissan-Datsun recorded the highest sales in Kenya, controlling 20% and 23% of the market respectively.

*Table 7- 17      Products and Market Share - DT Dobie & Co. Ltd. (1991)*

Product	Market Share (%)	Market Share of leader (%)
1. Nissan Sunny	33%	33%
2. Nissan Sunny Estate	53%	53%
3. E-23 Minibus	52%	52%
4. Datsun 1/2 P/up	65%	65%
5. Sahara d-21 p/up	4%	43%
6. Sahara 4WD	13%	26%
7. 3 ton Nissan trucks	-*	-
8. Mercedes trucks (ten tons)	2%	42%
9. Nissan UD bus	53%	53%

\*Figures were not available for 1991

*Source: Field Notes (1992/1993)*

## PRODUCTION ORGANISATION

### ORGANISATION OF PRODUCTION ACTIVITIES

Like Marshalls and Toyota, DT Dobie is an importer/distributor, without any internal capacity for production (assembly). However, as was noted, she has integrated backwards into assembly through part ownership of KVM (32.5% equity).

### PRODUCTION ACTIVITY FLOWS

In accordance with the Importer-Assembler agreement, DT Dobie procures inputs and delivers them directly to KVM's plant. Sourcing decisions are made by DT Dobie.

### SOURCING ACTIVITY

#### SOURCING BEHAVIOUR

DT Dobie managers were reluctant to disclose the names of some of their suppliers or the proportions of inputs sourced from such sources. The only suppliers disclosed were Autofilters Ltd. a DT Dobie subsidiary which supplies airfilters; RB Shaw Ltd. which supplies brake pads; and Burns and Blane and Sagoo Radiators who supply radiators. However, a list of items was provided. Clearly, these are only those items mandated by the government.

**Table 7-18**      *Outsourced Items - DT Dobie (1992/1993)*

Item	Supplier
1. Tyres and tubes	Firestone (EA) Ltd. (Large monopoly)
2. Airfilters	Autofilters Ltd (DT Dobie subs.) (Medium)
3. Brake pads	R B Shaw Ltd. (Medium)
4. Radiators	1. Burns and Blane Ltd (Small-Medium) 2. Sagoo Radiators (Small)
5. Batteries	Data not available (DNA)
6. Seats	DNA
7. Soft Trims	DNA
8. Glass	DNA
9. Spark Plugs	DNA
10. Wiring harnesses	DNA
11. Leaf springs	DNA
12. Exhaust systems	DNA

**Note:** Managers were reluctant to provide names of suppliers for some items for reasons of confidentiality.

**Source:** *Field Notes (1992/1993)*

It was estimated that DT Dobie outsources about 25-30% of its components and parts requirements, the rest come in as part of the CKD kit or imported directly from suppliers abroad. This finding coincides with the findings reported in preceding case studies.

In addition, half of marketing services are bought in, mainly in the form of advertising services. One quarter of all transportation services, and after-sales services are bought-in. Almost all legal services, insurance, catering, security, laundry and training are bought-in.

### **MOTIVATIONS FOR SOURCING BEHAVIOUR**

Like in all other cases discussed already, the main motivation driving transaction behaviour at DT Dobie is "necessity". Managers at DT Dobie argue that they have no choice but to source locally several items against "our better judgement." This was explained as the lack of good quality local products, a result of low level technologies used by local suppliers. This finding suggests that while buyers are 'willing' to buy locally, they are inhibited by the perceived poor quality of local suppliers. The factors outlined below in the following section were cited as influencing DT Dobie's sourcing behaviour.

### **FACTORS INFLUENCING SOURCING BEHAVIOUR**

As was noted in preceding paragraphs, only those items contained in the legal notices are outsourced and even then, only a small proportion of these. Clearly, like other franchise holders, DT Dobie appears to have responded to government pressure to outsource.

#### *Availability of suppliers*

Like other franchise holders, the recurrent theme in the interviews with DT Dobie managers is the general scarcity of good quality local suppliers. They argued that because it was difficult to find reliable local firms, DT Dobie is left with no option but to source from abroad. They also emphasised the lack of 'choice' for many inputs. For example, one manager noted that they have had problems with suppliers of glass but because the supplier is the sole producer of particular types of toughened glass, this limits their ability to source from alternative suppliers. Even in those cases where there were several suppliers, it was argued that the general level of technology used in Kenya does not match international standards.

#### *Quality of products*

This is related to the question of availability of good quality suppliers. Giving reasons of poor technological and managerial capabilities, DT Dobie managers expressed concern about the quality of local products. Hence, their sourcing decisions have been influenced by the availability of

products of international quality. One of the managers noted that because the components sector has been dominated by small and medium firms, and given the difficulties which this category of firms experiences in accessing finance, there's likely to be little progress in achieving the quality standards set by the manufacturers. He noted further

"The manufacture of components requires a very high level of skill and capital investment. Many of the small firms in this country cannot finance these requirements, and end up making do with obsolete machines while employing old methods of production. Given this scenario, one cannot expect high quality products."

### *Reliability of suppliers*

The reliability of suppliers was also cited as a factor influencing sourcing activity. In this case, it was argued that local suppliers do not have the capability to deliver the quantities required by the franchise holders within the required period of time. DT Dobie managers argue that one of the reasons for poor supplier reliability is their size - small firms do not have sufficient capacity to meet their volume requirements. One of the 'explanations' provided by DT Dobie managers is the proliferation of makes and models.

Like the other franchise holders discussed in preceding sections, DT Dobie managers argue that the model proliferation makes it difficult for such small local suppliers to cope with the product mix demanded by DT Dobie.

### *Access to foreign exchange*

Like the other franchise holders, the lack of access to foreign exchange by suppliers has two main effects on DT Dobie. First, because suppliers are reliant on imported inputs, the current foreign exchange restrictions have created a shortage of inputs. Consequently, suppliers have had difficulties in meeting their delivery and quality targets. Secondly, because such inputs are procured from 'expensive' sources, or foreign exchange has had to be 'bought' from alternative, often non-official sources, their prices have more than doubled in the last two years.

### *Cost of materials*

Another factor cited by DT Dobie managers is the cost of materials used by local suppliers and how it impacts on the prices of the finished parts and components. They argued that local firms have to contend with escalating costs of production brought about by high duties and taxes, and also the use of imported inputs. Consequently, their products are more expensive than imported products. Linking this factor to that of deletion penalties by manufacturers, they argued that purchasing inputs locally makes their final products less competitive.



### *Organisational policy and strategy*

Unlike GMK, and like AVA and her contractors, DT Dobie has no specific organisational policy nor strategy to source locally. It was also evident from the interviews that DT Dobie do not perceive local supplier conditions to favour local sourcing.

## **BUYER-SUPPLIER RELATIONS**

### **SUPPLIER DEVELOPMENT ACTIVITY**

DT Dobie does not have specific supplier development activities. As one manager put it "we have problems coping with the effects of the recession without taking on those of our suppliers!" Clearly, all suppliers are expected to be self reliant, even in the case of their subsidiary, Autofilters. The rationale provided by DT Dobie managers for this approach is the belief that Autofilters is a functionally autonomous company which should gain competitiveness without the parent company's assistance.

### *Contracting*

No specific contracts are made between DT Dobie and its suppliers, except with KVM, their assembler. Orders are made on a need basis, usually with a two to four week lead-time. Thereafter, communications between DT Dobie and her suppliers are specific to the order. This finding is similar to the cases described in the preceding case studies.

### *Transaction dependence*

Being an intermediate organisation, DT Dobie totally depends on its assembler, KVM, for all its assembly requirements. In addition, DT Dobie's purchases from local suppliers account for an average of about 60% of the company's requirements for any particular input, the rest being procured from abroad. In cases where suppliers were monopolies (e.g. tyres and tubes) DT Dobie procures all its requirements locally. In turn, DT Dobie managers estimated that because their other suppliers also supply other franchise holders (and assemblers), they are unlikely to be completely dependent on DT Dobie.

### *Trading patterns*

Like all other cases presented in preceding sections, the trading patterns evident at DT Dobie are of a short-term nature, usually lasting the duration of the order.

### ***Quality issues***

As already mentioned, because of the company's primary concern for quality, only defect free products are accepted from the supplier. DT Dobie does not bear the costs of replacement of any damaged goods. This reinforces the ACR type of relationship between DT Dobie and its suppliers. Having said that, DT Dobie's quality control officers check the quality of goods before they leave the supplier's plant. In addition, these are checked again at the KVM plant and any defects notified to DT Dobie's purchasing department, who then communicate with the relevant supplier.

### ***Communication with suppliers***

DT Dobie co-ordinates all the inputs and services relating to its franchise. Hence, there's frequent communication between its purchasing department and the sales departments of its various suppliers. However, only information relating to the order is exchanged. For example, DT Dobie rarely follows up supplier's problems unless they directly relate to their order. In most cases, if a supplier had internal problems it (the supplier) tried to deal with them without involving DT Dobie. According to Sako's typology, this denotes arms (ACR) length relations.

## **BUYER PERCEPTIONS OF SME SUPPLIERS**

### **CHARACTERISTICS OF SUPPLIERS**

The characteristics of DT Dobie suppliers are similar to those outlined for Marshalls and Toyota. they buy from large companies, most of whom are monopolies. They also buy from small and medium firms. However, the exact distribution cannot be given due to information limitations (see *Table 7-18*)

### **PREFERRED CHARACTERISTICS OF SUPPLIERS**

DT Dobie managers expressed their preference to transact with medium or large firms, arguing that local small firms are often "lax in their general approach to business". This was interpreted as a general poor quality of products, a somewhat unprofessional approach to doing business, and generally unreliable. Consequently, reasons given for preferring large firms is their ability to assure quality due to their accumulated technical expertise including warranties and insurance for products supplied. It was also argued that larger firms are concerned about their reputation in the market, and are therefore likely to deliver on time.

On the other hand, DT Dobie managers were keen not to rule out the advantages of transacting with smaller firms. They argued that despite their other weaknesses, small firms are more flexible. In addition, a firm such as DT Dobie has considerable bargaining power with such firms. An

interesting factor related to the flexibility of small firms is that because small firms tend to deal in a narrow range of products, they are likely to provide more specialised service.

### **FORMING INTER-FIRM RELATIONS WITH SMALL FIRMS**

In order to establish DT Dobie's attitude towards linkages with small firms, managers were asked what sizes of firms they preferred to transact with. It was clear that DT Dobie's main concern was the quality of the final product. It was therefore not important what size of firm supplied the inputs. However, to qualify this attitude, managers at DT Dobie argued that the concept of quality was closely linked with the technological and managerial capabilities of local suppliers. It was argued that local firms tend to have lower quality products, operate in a "haphazard way" making it difficult to transact. This coincided with the findings of the previous cases.

It was also evident that similar to the situation at Toyota, Marshalls and GMK, DT Dobie's concern is with the continuous flow of inputs to the production line. For this reason, her managers prefer to receive the CKD as a complete kit.

### III COOPER MOTOR CORPORATION (CMC)

#### BACKGROUND

This case presents findings regarding the Cooper Motor Corporation (CMC), which is part of the CMC Motor Group of companies. All of these companies are, in turn, part of the CMC Holdings Ltd., a wholly owned Kenyan company. The holding company comprises CMC (Kenya) Ltd. (various vehicle franchises); CMC Engineering Ltd.; CMC Aviation Ltd. (aviation school and charter firm); CMC Management Services Ltd.; Abacus Data Ltd. (a computer bureau); VW Rent-A-Car Ltd (car rentals); Cooper Davies Air Ltd. (air charters); CMC Aircharters Ltd.; Tubogo Cooper Motors Ltd.; Dobie Cooper Motors Ltd. (joint venture dealerships with DT Dobie - CMC 90% and DT Dobie 10% ownership); KVM assemblers (32.5% ownership); and CMC Uganda.

The CMC Motor Group, comprising five divisions, 'manages' the motor vehicle franchises.

*Table 7-19 CMC Motor Group Structure (1992/1993)*

Division	Franchise(s)
1. Land Rover Kenya	6 models of Land Rovers (Discovery, Defender, and Range Rover)
2. CMC Kenya Ltd.	1. VW/Audi franchises 2. Mitsubishi (Pajero) franchise 3. 4 models of Suzuki 4. Mini Moke 5. Mitsubishi L 300 Minibuses and vans
3. HCV (Heavy Commercial Vehicles) Division	1. Leyland DAF 2. Ashok Leyland 3. Nissan Diesel (3 models of buses, and 4 models of trucks) 4. Suzuki and Evinrude outboard motors
4. Mazda (Kenya) Division	Mazda franchise (1 passenger car, and 2 models of light commercial trucks)
5. Hughes Agric. Division	1. Earth moving equipment 2. Ford tractors

*Source: Field Notes (1992/1993)*

#### FORMATION AND OWNERSHIP

The Cooper Motors Corporation Ltd. was incorporated in July 1948 to market the *Land Rover*, which has since become the flagship of the company. In 1951, CMC took on the VW franchise, marketing the *VW Beetle*. At the same time, CMC expanded into Tanzania and Uganda. These

branches were, after independence, incorporated as independent trading companies in their respective countries. In Kenya, CMC Holding Ltd. was incorporated to manage CMCs varied Kenyan interests. In 1973, CMC Holdings bought Ben, Bros. Ltd., thus transferring the Leyland, Morris, Jaguar franchises to CMC. In 1983, part of the Hughes Ltd. were purchased by CMC Holdings, although both interests were run as independent companies under the umbrella of the holding company. In 1991, CMC Holdings bought the remaining Hughes shares. CMC Motor Group was formed in 1991 to bring together CMC (K) and Hughes Ltd, with the company restructured on divisional lines as outlined in *Table 7-19* above.

CMC Holdings Ltd. is a public company quoted on the Kenyan Stock Exchange with 21% of the shares held by the Government of Kenya while the rest are held by the public.

## PRODUCTS AND PERFORMANCE

CMC's market performance is recorded in the 4WD segment with three of its franchises leading the segment. The most prominent CMC product is the *Land Rover*, which, for over three decades since CMC's inception, was the only Four Wheel Drive vehicle marketed in Kenya. Because of the rough Kenyan terrain, it has continued to serve as the most popular cross country vehicle. However, for the past three years, its best performer in terms of sales has been the Suzuki Sierra which combines the Land Rover's qualities with "more modern styling". Other CMC Motor Group franchises have been less successful. *Table 7-20* shows the group's relative performance in various vehicle market segments.

In 1991, the Mitsubishi make ranked second overall, with an 18% market share, behind the Nissan-Datsun makes which had a 20% share of the total market. The Mazda and Suzuki makes ranked sixth and seventh with market shares of 6% and 4% respectively, while the Land Rover ranked eleventh with a one percent market share.

## PRODUCTION ORGANISATION

### ORGANISATION OF PRODUCTION ACTIVITIES

Like Marshalls, Toyota, and DT Dobie, CMC is an importer/distributor, with no internal capacity for production. However, CMC has vertically integrated extensively in the motor vehicle industry, having a 32.5% shareholding in the KVM assembly plant, as well as joint ownership with DT Dobie in dealerships. CMC Holdings Ltd. subsidiaries and associated companies also provide a proportion of CMC's requirements, including Computer services from Abacus Data Ltd.; domestic air transport services; and components and sub-processes from CMC Engineering.



## PRODUCTION ACTIVITY FLOWS

As at DT Dobie and the AVA franchise holders, CMC procures inputs directly from its franchisors, and delivers them to the KVM plant. Hence sourcing decisions are made by CMC in accordance with the various agreements with the franchisors and the assembler.

**Table 7-20**      *Products and Market Share - CMC Motor Group (1991)*

Product	Market Share (%)	Market Share of Segment Leader (%)
1. Suzuki Sierra	47%	47%
2. Mitsubishi Pajero	25%	47%
3. Land Rover	5%	47%
4. Mazda Miujiza	30%	65%
5. Mitsubishi L200	11%	23%
6. Land Rover	2%	23%
7. Mazda B16	7%	23%
8. Mitsubishi L300	3%	52%
9. VW Transporter	No data	
10. Mitsubishi Canter	14%	83%
11. Mazda T4100	3%	83%
12. Mitsubishi Canter (L/Truck)	39%	43%
13. Mazda T4100 (L/Truck)	10%	43%
14. Nissan Diesel (Truck)	36%*	Data not avail.
15. Leyland (Truck)	5%*	Data not avail.

\* Divisional aggregate provided by CMC. Other data relates to comparable market segments as provided by KMI.

*Source: KMI Vehicle Sales Statistics (1992)*

## SOURCING ACTIVITY

### SOURCING BEHAVIOUR

The sourcing pattern observed at CMC is similar to that observed in the previous case studies. CMC locally sources only those items contained in the Legal Notices. She also uses more or less the same local suppliers as the franchise holders already discussed. CMC also outsources advertising services (80%) from Edforce Ltd.; distribution services (dealers) (25%) and the rest from a sister company Dobie Cooper Motor Corporation (DCMC); Information and computer services (90%), sourced from a sister company, Abacus Data Ltd.; Legal and Insurance services (100%) training (50%); Cleaning and maintenance (60%); Security services (80%) from Kali

Guards Ltd. and Riley Security Ltd.; and Laundry services (100%) from Pearl Drycleaners Ltd. All of these companies were described by CMC managers as small firms.

### **MOTIVATIONS FOR SOURCING BEHAVIOUR**

Like in the preceding cases, the main motivation for transaction behaviour at CMC is necessity. Managers at CMC argue that they are 'forced' to buy from local sources because of government regulations. They further argue that they have experienced problems in obtaining good quality products locally because of the lack of reliable suppliers. This finding suggests that given prevailing conditions, CMC managers would prefer to purchase their requirements from abroad, at least, as part of the CKD kit. The Parts Manager remarked, "It is an unwise managerial decision to buy locally. [But by buying locally,] we jeopardise the quality of our final product, and it is expensive".

### **FACTORS INFLUENCING SOURCING BEHAVIOUR**

As was noted in preceding paragraphs, like other franchise holders, CMC outsources only those items listed in the Legal notices, clearly responding to government pressure for localisation. Several reasons were cited for this behaviour. As will be noted, these are similar to those cited by franchise holders discussed in preceding sections.

#### *Availability of Suppliers*

Like other franchise holders, CMC managers believe that the most prominent factor inhibiting local sourcing, particularly from small local firms, is their absence. Emphasising the complexity of this problem, one manager argued that "the question, in fact, is not simply whether they exist or not. We are concerned about their ability to deliver the quality that we want". Clearly, CMC managers are concerned about the ability of local suppliers to meet international components standards. This raises the question of the quality of local products.

#### *Quality of products*

The previous cases describe the question of quality in relation to the lack of comparable components on the local market. While referring to the same issue of quality, one CMC manager explained that to their company,

"we are talking of that quality that keeps us at the top of the market. It is not just good quality, but excellence. It is difficult to find that kind of quality among most local suppliers".

Singling out poor financing and equipment of local firms, the same manager further noted that the development of local firms has been hampered by poor support from the government and other development institutions.

*Table 7- 21 Outsourced items and suppliers - CMC (1992)*

Item	Source (and size of firm)
1. Air and oil filters	Autofilters Ltd. (Medium)
2. Spare Wheel carriers	1. E A Motor Industries Ltd. (Medium) 2. CMC Engineering Ltd. (Medium)
3. Wiring Harnesses	1. Autospring Manufacturers Ltd. (Medium) 2. Automotive Products (K) Ltd. (Small-Medium)
4. Leaf Springs	1. Autospring Manufacturers Ltd. (Medium) 2. Auto Ancillaries Ltd. (Medium)
5. Shackle Pins	1. Autospring Manufacturers Ltd. (Medium) 2. Auto Ancillaries Ltd. (Small-Medium)
6. U-bolts and nuts	1. Autospring Manufacturers Ltd. (Medium) 2. Auto Ancillaries Ltd. (Medium)
7. Seat frames	1. Silentnight (K) Ltd. (Large) 2. Megh Cushion Inds. Ltd. (Large)
8. Speedo cables	Express Moparts Ind. Ltd. (Small-Medium)
9. Wheel spanners	Auto Electric Services Ltd. (Medium)
10. Toolkits	Alibbahi Sharif & Sons Ltd (Medium merchant)
11. Radio/Radio-cassettes	1. Sanyo Armco (K) Ltd. (Large) 2. Stenorette & Radio Services (Medium)
12. Brake pads and disc pads	R B Shaw Ltd. (Medium)
13. Soft trims	1. Silentnight (K) Ltd. (Large) 2. Megh Cushion Inds. Ltd. (Large)
14. Canvas hoods	Bonar (EA) Ltd. (Medium-Large)
15. Exhaust systems	1. Auto Performance Ltd. (Medium) 2. Mann Manufacturers Ltd. (Medium)
16. Scissor jacks	Auto Performance Ltd. (Medium)
17. Radiators	1. Sagoo Radiators Ltd. (Small) 2. CMC Engineering (Medium)
18. Safety belts	1. Megh Cushion Ind. Ltd. (Large) 2. Burns and Blane Eng. Ltd. (Medium)
19. Flat and curved flattened glass	Impala Glass Inds. Ltd. (Large monopoly)
20. S/Absorbers	Hill Products Ltd (Medium)
21. Batteries	Associated Battery Manufacturers Ltd. (Medium)
22. Tyres and Tubes	Firestone (EA) Ltd. (Large monopoly)
23. Tow hooks	CMC Engineering Ltd. (Medium)
24. Spark plugs	Car & General (K) Ltd. (Large)
25. Hydraulic jacks	1. Car & General (Large) 2. Industrial Hardware (Medium)

*Source: Field Notes (1992/1993)*

### ***Reliability of suppliers***

CMC managers perceive their reputation to be founded on the reliability of their products and staff, within the market. They expect, therefore, a similar level of reliability from their suppliers.

"So far, we have had a few problems with one or two local suppliers. We cannot take too many risks by buying locally where we can buy from more reliable sources abroad. Obviously, we are currently restricted by government regulations".

This finding denotes that CMC managers have doubts about the reliability of local suppliers. They also argue that due to quantity and quantity demands by CMC, local suppliers are unlikely to deliver required products on time and to desired quality.

### ***Supplier's access to foreign exchange***

Like the other franchise holders, CMC consider the problems of local sourcing to be linked to the lack of access to foreign exchange by local producers. They argue that because local producers of components use an average of 60% imported materials in their products, its frequent scarcity has caused frequent shortages in the supply of inputs to the assemblers. Suppliers have had difficulties in meeting delivery and quality targets, rendering them "an unwise business option" for the franchise holders. In addition to this problem, 'extra' costs arise from the use by suppliers of alternative sources of foreign exchange, which tend to be more expensive.

### ***Cost of inputs and pricing of components***

Another factor cited is the high cost of local components aggravated by a combination of factors discussed in preceding sections. Together with the desire to avoid deletion penalties by the manufacturer, the relatively higher cost of local sourcing has prevented CMC from using local suppliers. "Even taking the higher transportation costs from overseas into consideration, it still cheaper to source abroad".

### ***Lead time***

CMC managers perceive lead-time required for sourcing from overseas the most important factor affecting their company. Like GMK, CMC managers felt that if local supply conditions were better they would have preferred to source locally given the lead-time conditions. Lead-time is seen

### *Organisational policy and strategy*

Unlike GMK, and like other franchise holders, CMC has no specific policy to develop suppliers, or to buy products locally. CMC sources from companies that already have the capability to meet its requirements, and hence, the company takes responsibility for its own development.

### **BUYER-SUPPLIER RELATIONS**

On the whole, buyer-supplier relations between CMC and her suppliers can be described as arms-length (ACR), with no specific commitment on the part of CMC to develop the suppliers.

### *Supplier development activity*

Like other franchise holders, CMC does not have supplier development programmes. Evidently, suppliers are expected to develop their own enterprises, and any problems with delivery and quality are the responsibility of such suppliers.

### *Contracting*

Under the agreements for the procurement of CKDs, a six month firm order lead-time is provided for. In practice, a three to four month firm-order lead-time has continued to operate.

Local procurement, however, does not operate on contract. Instead, like AVA, Marshalls, Toyota, KVM and DT Dobie, an order form is deemed sufficient to initiate a transaction.

### *Transaction dependence*

As a coordinative, intermediate organisation, CMC is totally dependent on KVM for assembly of vehicles, and both foreign and local suppliers for components and parts. In cases where a supplier is a monopoly, or existing suppliers are not suited to CMC's needs, there is more dependence on one supplier. For other items, however, CMC retains more than one supplier as an assurance against loss of control. For example two firms supply CMC with soft trims. Both are relatively large firms in the furniture and upholstery industry. CMC manager believe that because of their size (and relative 'power' in the industry) they are more likely to increase prices more frequently, and less likely to meet delivery commitments than would smaller firms.

### *Trading patterns*



that, CMC managers noted that it is in CMC's interests not to change suppliers "unless there is a good reason such as poor quality, unreliability, or unreasonably high costs."

### *Quality issues*

With production focused on quality, only defect free components are accepted from suppliers. Like other franchise holders, CMC does not take responsibility for rectifying defects, or indeed actively assisting the supplier to deal with them.

### *Communication with suppliers*

CMC co-ordinates all inputs associated with its franchises, hence, there's frequent communication with suppliers. However, this communication only related to the orders - agreeing to specifications and making sure that they are achieved. Information about the organisational problems, or otherwise, of the supplier is not exchanged. In addition, the supplier does not get any information about CMC that does not relate to the order. This reinforces the ACR relations described above.

## **BUYER PERCEPTIONS OF SME SUPPLIERS**

### **CHARACTERISTICS OF SUPPLIERS**

CMC's suppliers are predominately small or medium sized firms, excepting cases such as tyres and tubes where there is only one supplier who happen to be large. CMC managers rationalise this 'preference' by arguing that few large firms operate in the parts and components sub-sectors due to the high investments required, relative to the small and fragmented vehicle market in Kenya.

### **BUYER PREFERENCES OF SUPPLIER CHARACTERISTICS**

Despite apparent predominant use of small to medium sized suppliers, CMC managers expressed a preference for medium or large "well organised" firms. They argued that small local firms have a tendency "not to take things seriously". However, "the operative word is 'organisation' of the firm we deal with. By this I mean we are not really concerned with a supplier's size, but with their ability to meet our needs."

## **FORMING INTER-FIRM RELATIONSHIPS WITH SME FIRMS**

Like DT Dobie, CMC did not express any particular preferences about the size of firm they transact with as long as they can deliver quality products when they are required. The Parts Manager saw this as a "wise strategy" since, "our main concern is with quality. In Kenya, you cannot afford to be choosy. There are not enough suppliers around. Who provides what we want does not matter, so long as the quality is right".

## SUMMARY AND CONCLUSION

This case has described KVM and two of her contractors, DT Dobie & Co. Ltd and CMC Motor Group. Like AVA, and unlike GMK, KVM is a contract assembler making only a few direct purchases of inputs and services, the bulk of which are made by the franchise holders (the contractors).

In summary, sourcing activities at KVM and its associated contractors follows the pattern observed at AVA. Only those items listed in the Legal Notices are outsourced, the rest coming in the form of a CKD kit. Although these are outsourced from small and medium local firms, managers stated that they preferred to source from larger firms for their perceived ability to meet the buyer's quality and delivery requirements.

Other factors influencing sourcing behaviour were found to be related to the perceived weaknesses of the local supplier infrastructure: unavailability of good quality suppliers; poor quality of local products; frequent changes in engineering and vehicle model changes; high cost of local inputs; lack of access to foreign exchange by local supplier; and lack of organisational policy or strategy to use local suppliers or to develop a local supplier base.

## CHAPTER EIGHT

### CASE SYNTHESIS AND DISCUSSION

#### 8.1 INTRODUCTION

The broad aim of this study was to explore how large firms can be encouraged to use small firms as suppliers or partners as a strategy for SME development. It was argued in chapter one to four, that this requires first, an assessment of whether large firms have the propensity and motivation to form inter-firm linkages with small firms; and second, an understanding of those factors which condition the formation of inter-firm relations.

The literature has suggested, in general, various motivational factors which stimulate inter-firm relationships, such as flexibility, the search for core competence, and supplier chain management. However, in the main, particularly with regard to vehicle industries in other countries, it has focused on the underlying motive of efficiency and related cost effectiveness. Consequently, all secondary motivations such as access to resources have been viewed from the efficiency perspective. This study proceeded on the proposal that large firms in Kenya's motor industry are more likely to internalise activities than externalise them and use inter-firm linkages. It further suggested that if they do use any inter-firm linkages, other factors, besides the cost minimisation motives suggested in the literature, stimulate their formation. In the findings of the study conducted in Kenya and reported in a descriptive form in chapter seven, it is suggested that inter-firm linkages are largely formed as a response to legislative compulsion rather than 'voluntarily'. In this case, the managerial strategy adopted, it would seem, is compliance with the compulsion in order to access resources and markets at some point in the future. This chapter synthesises and discusses the findings from the cases within the broad frame of the inter-firm relationship formation and strategic behaviour literature.

Because of the nature of the research design, this analysis adopts a "cross-case analysis" approach. Miles and Huberman (1984) argue that this approach allows the investigator to progress from description and partial analysis (chapter seven) to an interpretative level of analysis. They note

"Doing a cross-site analysis with a core list of variables determined to have significance across several sites is the most powerful way to move from partial to an interpretative explanatory account." (p197)

Although a core list of variables was not used in this study, specific issues were studied across all the cases investigated.

This chapter also brings together the observations made in the case studies in an effort to consolidate methodology and observation with theory, as a strategy for moving beyond particularistic observations and to link observations to theory (Denzin, 1970). This means that conclusions and inference are part of the analysis (Moser and Kalton, 1971). During this process, the analysis draws from existing knowledge, but also makes use of intuition (Miles and Huberman, 1984).

The work presented here does not claim the statistical representativeness of the cases to the wider population, and agrees with Miles and Huberman (1984) who argue that research findings need not be assumed to be typical, or representative of a more general phenomenon. The study, as noted previously, aimed to 'describe and explore' rather than make generalised inferences about the behaviour of the population. Nevertheless, some important propositions emerge and are important in setting the agenda for further research. The interpretation of the data presented in this thesis, therefore, aims to make some proposals rather than make claims to being representative of a population. In this respect, numerical "evidence" is not as important as the "theoretical" suggestions made by such evidence (Yin, 1984). It is the patterns replicated in succeeding case studies that contribute toward the generation of theory, rather than the quantification of incidences.

In total, seven cases were studied in a multiple case study approach. Three 'main' cases which formed the core of the study, were examined. Additionally, four sub-cases from the importer category were examined. The latter category is a result of the nature of production organisation in two of the three main cases studied, where the assembler and 'importer' functions are carried out by separate firms. All of these cases are what are referred to in Kenya as 'large' enterprises (employing more than 100 people). The rationale for focusing on large firms has been discussed in chapters one and six where it was posited that as major players, large firms are likely to initiate industry-wide activity. In addition, in chapter five, it was further argued that in an environment where large firms dominate an industry, their decisions and actions condition industry behaviour. They can, therefore, be considered an important initial focus for an industry wide study. Besides, in a buyers' market such as pertains in Kenya's component industry, it is critical to study, initially, the buyer category, since their decisions are likely to influence the nature and extent of inter-firm relationships within the industry.

The evidence from these case studies is used to test the guiding hypothesis (see chapters 3 and 6) that SME development through linkages with large firms is predicated on the large firms' propensity and motivation to dis-aggregate or externalise their activities, and outsource from small

firms. In turn, this is predicated on the large firm's perceptions about the 'suitability' of SMEs as suppliers, and what impediments, if any, are likely to hinder this outcome. Hence, the two questions introduced in chapter one guide this analysis:

- (1) Do large firms in Kenya's motor vehicle industry have the propensity and motivation to dis-aggregate, and outsource? In other words, is their production organisation conducive to outsourcing?
- (2) Do large firms in Kenya's motor vehicle industry have the motivation to outsource from SMEs? What are the perceived factors influencing their sourcing activity? What is the nature of relationships between buyers and suppliers?

A third question is important in putting the findings of this study within a theoretical context.

- (3) What wider lessons can be drawn from the findings of this research with regard to existing theory on inter-firm relationship formation in general, in the motor vehicle industry, and in a developing country context.?

These questions are addressed in terms of the production organisation by firms in the motor industry, their sourcing activity, the prevailing buyer-supplier relationships, and the prospects for forming inter-firm linkages with small firms.

## **8.2 PRODUCTION ORGANISATION IN KENYA'S MOTOR ASSEMBLY INDUSTRY**

It was argued in chapter three that for inter-firm linkages, particularly with small firms to take place, large firms must have a production organisation approach which allows de-coupling of activities. They must exhibit discrete processes and activities which, on a technological level, allow them to dis-aggregate should it become a corporate strategy, to provide a framework for inter-firm relations. This is predicated on the firms' perception of the need to dis-aggregate production. The literature, using examples such as steel production, argues that in industries where production organisation does not allow de-coupling, lower levels of vertical de-integration are expected.

The research reported here reveals that like the vehicle industries elsewhere, production organisation in the Kenyan vehicle assembly industry is generally dis-aggregated and hence this



distribution, and after-sales service are conceptually separate activities which potentially can be performed by different firms. Arguably, therefore, there should not be production organisation related reasons why large firms cannot dis-aggregate and externalise activities.

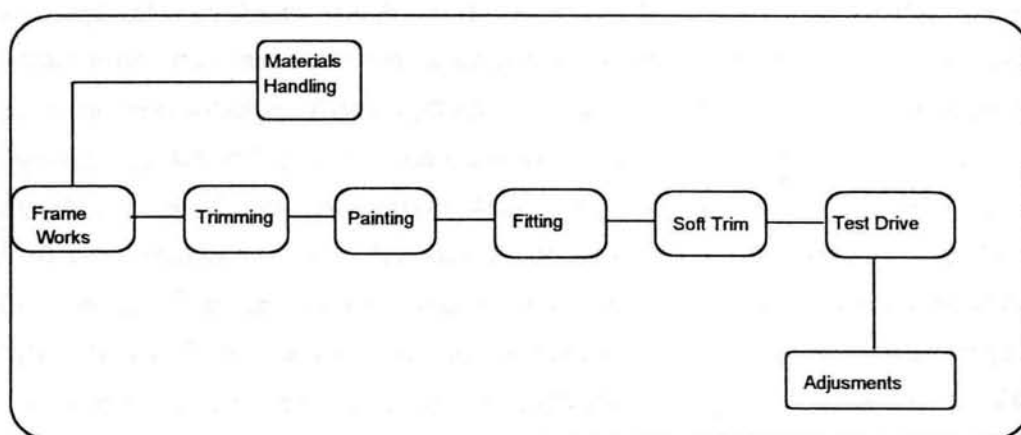
This finding is important for the broad framework suggested in chapter two. It was argued that the principles of flexible specialisation and lean production suggest a framework within which to interpret production de-integration. It argues that for various reasons, fragmentation takes place in large enterprises and inter-firm relationships used to bridge the supply gap arising. This study found that as expected, at the level of the firm, there is potential for fragmentation since services as well as various parts and components can be de-linked from the assembly process. However, it was also found that the use of inter-firm linkages is limited to compulsory items. The next step is to establish whether the actual organisation of production activities facilitates de-integration and if not, what factors prevent it.

### 8.2.1 PRODUCTION ORGANISATION

At the level of the firm, however, activities can be broken down further into various processes and sub-processes as shown in *Fig. 7-2* and *7-4* in chapter seven. The differences in the various cases is presented under each case study. All the assemblers have 'flexible' assembly lines in order to facilitate the assembly of the large number of makes and models. By this is meant the ability to re-tool and change jigs and other equipment after each production run. However, the organisation of the actual assembly activity is fully integrated - all the sub-processes lead directly into each other, making it difficult to de-couple the main assembly process. Except for the material and services inputs, all other activities are linked. Consequently, once the CKD is delivered to the assembly line, there seems to be little opportunity for outsourcing. However, there are opportunities at the levels of materials and services sourcing. For example, services such as transportation of CKDs from the port to the assembly plants, security and laundry services are sourced from different suppliers and 'fed' into the process at different levels. As discussed in chapter seven, all the cases studied 'bought-in' an average of 80% of their service requirements. Arguably, this is to be expected in a manufacturing enterprise, particularly if the services are of a specialist nature. Arguing from an efficiency perspective, and in view of Prahalad and Hamel's (1990) concept of core competence, firms are unlikely to have a high level of specialist competence needed for in-house production of most services.

This finding establishes that at the broad production activity level, vertical de-integration can be expected because of the production organisation which offers opportunities for de-linking of materials procurement, assembly, distribution, and after-sales services. At the assembly process level (the level of the firm), however, this is difficult because the current production techniques

integrate all these processes in what appears to be a continuous flow of activities. The following description of processes derived from the case studies illustrates the integration at assembly level. It is important to note that at this level, the assemblers exhibit an identical pattern of production organisation (see *figs. 8-1* below)



**Fig. 8-1 Assembly Activity Outline**  
Source: Field Notes (1992/1993)

1. *Materials handling:* When CKDs and local materials are received, quality control checkers go through the despatch documents, verifying the quality and quantities of deliveries. The various parts and components are then unpacked and despatched to their respective work stations within the plant.
2. *Frameworks:* Using pre-assembled jigs, the frame of the vehicle is assembled from the CKD kit. The panels are welded onto the frame-work. This is loaded onto a wheeler which is the main method of conveyance of the vehicle until it is ready for a test drive. The conveyor belt system is not used in any of the assembly plants.
3. *Trimming:* involves modifying the vehicle frame according to specifications. Often this involves panel beating and shaping.
4. *Painting:* The vehicle shell is then pre-treated against rust and then painted.
5. *Fitting:* This involves fitting the essential components of the vehicle i.e. the engine, gearbox, front/rear axles, dashboard, etc. Vehicles which have a chassis are assembled on the chassis.
6. *Soft Trimming:* This involves adding interior trimmings to the vehicle's shell. This includes upholstery fitting, lining, and carpeting.

7. *Test Drive*: This subjects the vehicle to a road test. Adjustments are made to correct any defects before the distributor takes physical possession of the vehicle.

Given this assembly activity organisation, all the cases studied reported outsourcing of various inputs, CKDs being the major input outsourced, but always from manufacturers abroad. GMK is the only assembler importing CKDs from a sister company. In addition, it is not vertically integrated with other companies within Kenya. Hence, any local outsourcing activities are with independent firms rather than sister companies like is the case for AVA and KVM. Its vertical integration pattern is, therefore, at the intentional level (MNC or TNC) while the other assemblers are integrated at the national level. This has implications for local industrialisation. Vaitos (1991) has argued that the Kenyan government fears that TNCs do not always have national industrialisation interests in mind when they formulate policy at the corporate level. Hence, GMK's activities, while currently favourable for local inter-firm sourcing may not be entirely predictable, and may be reversed at a later date by changes in sourcing strategies at the corporate level. For example, in the event that legislation restricting importation of components is lifted, such an internationally integrated firm is more likely to source many of its requirements from sister companies abroad. The broader implication of this finding is that there seems to be limited 'control' over the activities of such a firm, since corporate policy is an important factor in its behaviour. Hence, there are limitations to long-term planning by the government for localisation and local SME development.

However, this does not imply that the nationally integrated firms will use local suppliers automatically in the case of removal of legislation. It is probable that they too are likely, in the short-term, to use other sources, particularly overseas suppliers, as this may be argued to be more cost effective, or to offer better quality products. This implies that currently in those firms integrated at the local level, vertical integration is used as a strategy to minimise the cost of importation, and the risks of using local suppliers who are under the direct control of the firms.

The finding that GMK sources from independent local firms is, however, promising. This implies that currently, GMK provides some potential for SME development activities since it uses fewer intra-firm transfers. On the other hand, as noted in chapter seven, the other assemblers are themselves part of a vertically integrated system with few opportunities for independent firms to supply them, or to form strategic alliances with them. The study also reveals that in turn, the main contractors of AVA (Marshall's and Toyota) and KVM (DT Dobie and CMC) are also integrated into the components and parts industries as, according to one manager, "an assurance against resource scarcity or the possibility of our competitors controlling the input market". The study also revealed that the franchise holders are integrated into the distribution of vehicles and spare parts, and horizontally into other motor vehicle related activities such as motor cycle marketing and

servicing, aviation, and fuel distribution outlets. This finding confirms the market failure thesis argued by authors such as Stuckey and White (1993) and Doner (1993).

The firms studied reported that because of the absence of alternative suppliers, they found it prudent to invest in those activities for which they have current or expected demand. It is interesting to note, however, that these firms do not depend only on internal demand for the survival of their subsidiaries. Burns and Blane, for example, is a subsidiary of Toyota Kenya, which produces radiators for all the assemblers and importers. They also serve the replacement market, particularly for those makes and models already assembled in the country. Evidently, the logic for integration can be argued to be rational since the subsidiary is not dependent on the small, highly differentiated demand of the parent company. This analysis suggests that there are incentives for vertical integration since subsidiaries can operate semi-autonomously, and serve other buyers in addition to intra-firm transfers with the parent company. Integration has also been argued to result from 'poor quality suppliers'. In this regard, as noted in the Marshalls case, there are plans to invest in the local production of shock-absorbers since local suppliers cannot meet Marshalls' "quality and delivery" requirements.

The findings discussed here have important implications for emerging theories about flexible specialisation, lean production and downsizing of firms. They lead to the conclusion that there are limited prospects for SME development given the current production organisation in the Kenyan vehicle assembly industry. The main limitation is the way the assemblers have organised their activities to deal with perceived resource scarcity, and the availability of opportunities for investing in different stages of the production chain (Stuckey and White, 1993). In both cases, market failures arise, with firms perceiving the incentive to use intra-firm transfers as an assurance of access to scarce resources, and related competitiveness.

They also lead to the conclusion that despite the small, highly fragmented markets in the motor vehicle industry in Kenya, where firms in other environments are reported to use inter-firm relationships to achieve flexibility, Kenyan firms are still reluctant to outsource. The explanations confirm Doner's (1993) and Masai's (1991) view that this reluctance is largely related to the perception of a poor supplier infrastructure. This finding also indicates that the fragmentation expected by the lean production thesis is not taking place. In fact, the firms studied did not indicate downsizing as a restructuring process aimed at efficiency, but as a reaction to the recessionary trends affecting industry in Kenya at the time of the study. Unavailability of foreign exchange for the procurement of CKD kits, for example, account for a large proportion of the reduction in employment (see chapter seven).

### 8.2.2 ORGANISATION OF INPUT PURCHASING

As reported in the introduction of chapter seven, this decision-making framework identified in the three assembly plants has interesting operational implications. GMK can import all its requirements (CKDs) and also make decisions about local inputs, while KVM and AVA only make decisions about a limited number of inputs. The majority of the inputs are bought by the importers/distributors. In the GMK model, the importer and assembler functions are fused into the same organisation, and differ significantly, therefore, from those at KVM and AVA. This can be attributed to the contractual agreements entered into by the assembler and the importer at the time of the contract to assemble (see for example, Appendix E). The contract emphasises three aspects of the relationship between the parties which motivated the emphasis on the importer rather than the assembler:

1. The duty of the assembler is to assemble. (Importer -Assembler Agreement p2)
2. The importer is under obligation to supply the CKDs, any local materials, training, technical assistance and equipment. (Importer-Assembler Agreement pp 2-6)
3. The Importer remains the sole Importer and distributor of the products, and shall also be responsible for clearing all imported materials ordered by it through customs and delivering the same to the plant. (Importer-assembler Agreement p3)

This scenario tempers the purchasing arrangements within the industry. Arguably, this production organisation pattern allows GMK as an assembler to make critical decisions about sourcing as part of an integrated production and/or structural policy. On the other hand, the production organisation adopted in the other two cases limits the scope for integrated sourcing policies.

A distinct variation in the purchasing activities under the various models is evident. At GMK, the purchasing department has closer ties with the supplier's whole operation, particularly in the cases of small and medium suppliers. This is consistent with the supplier development strategy adopted by GMK as an assurance against poor quality inputs from suppliers. The same does not apply at the other two assembler's plants since the purchasing function lies with the importer, except for the few items agreed upon as per the importer-assembler agreement. However, a liaison exists with the importers. In turn, a liaison exists between the importers and the suppliers. At this level, the importers' purchasing departments were found to liaise continually with the supplier's sales department.



### 8.3 SOURCING ACTIVITY IN KENYA'S MOTOR INDUSTRY

#### 8.3.1 SOURCING BEHAVIOUR

The sourcing behaviour of the three assemblers and their constituent importers does not differ significantly. All of the cases presented source locally only mandated items, and some services.

*Table 8-1 Aggregate Local Sourcing for All Assemblers (1992/93)*

Assembler	Estimated Local Sourcing of parts and components	Estimated Local Sourcing of Services	Estimated Sourcing from Local SMEs
GMK	37%	40%	70%
AVA*	40%	75%	65%
KVM*	30%	80%	70%

\* These figures are an average which includes the franchise holders/contractors

*Source:* Field Notes (1992/1993)

*Table 8-1* summarises at an aggregate level, the sourcing activities of large firms in the motor assembly industry in Kenya. Local sourcing of parts and components is low compared to the local sourcing of services. One of the explanations could be the fact that many manufacturing firms find the need to focus on manufacture, and to buy-in all required services. In addition, contrary to expectations given the perception by managers that local SMEs tend to be of a generally poor quality, the share of SME contribution is relatively high. About 70% of GMK's local suppliers can be categorised as SMEs while 60-70% and 70% of AVA's and KVM's local suppliers, respectively, fall within this category. This finding can be explained by the absence of large suppliers in the components industry. It is also probable that due to the small volumes required as a result of a highly fragmented vehicle market, large firms would have been unlikely to supply the industry. This is partly due to the current production organisation in Kenya's large firms, which still operate a mass production system. On the other hand, in all probability, this development can be explained by the structure of the industry itself where few large firms operate in the parts and components sub-sectors. As noted in chapter seven, large suppliers tended to be in sectors which had larger and wider new and replacement markets, while the smaller suppliers operated in input markets served by small or medium firms.

All the products outsourced were standard parts and components produced according to the manufacturers' specifications. Hence, there are few technologically specialised needs requiring specialised suppliers (Polanyi, 1967) as is the case with technology-based SMEs highlighted by Forrest (1990). Consequently, technology based strategic alliances and partnerships are less likely to occur in this particular context. This has a bearing on the nature and operational impact of an

assembly based industry. There are fewer opportunities for technological development as all parts and components come already manufactured, or as blueprints provided for their local manufacture and/or adaptation. Again, this has deleterious implications for industrialisation in developing countries where the technology levels are argued to be lower than those of their counter-parts in business. Without a generic manufacturing industry, little, if any, indigenous technology can develop as assemblers concentrate on meeting the immediate needs of the suppliers of kits, leaving little time or funds for R&D. In no case studied was there investment or direct involvement in generic R&D.

*Table 8-2* summarises the items outsourced by the assemblers and their contractors. Clearly, all the assemblers and franchise holders outsource only those items listed in the legal notices since none of these items are 'voluntarily' locally sourced. The table also highlights the fact that KVM and AVA outsource fewer items than GMK. This has implications for the ownership pattern in the industry. It would appear that the franchise/importer model has less potential for outsourcing and therefore would have fewer opportunities for SME development through large firm outsourcing activities.

### 8.3.2 FACTORS INFLUENCING SOURCING BEHAVIOUR

Local sourcing was used in this study to measure outsourcing - levels of local content. This argument also made the assumption that local sourcing draws into the net SMEs in the components sub-sector since it traditionally has more SMEs than large firms. Hence, the finding that an average of approximately 43% of the motor vehicle industry's requirements are locally sourced is a crude measure of sourcing from SMEs.

The research was interested in the factors which influence sourcing activity, based on the initial finding that large firms (buyers) outsource only mandated items. It was also found that while not having a specific preference for large or small sized firms as suppliers, a large majority of large firm suppliers are small or medium-sized businesses. As already noted in chapter seven and in section 8.3.1 above, one of the reasons given is that the components sector in Kenya is predominately populated by small and medium firms owing to the small and fragmented markets in the sector. *Tables 8-3 to 8-5* summarise the perceived factors, related to the buyer, supplier, and the business environment, influencing sourcing activity on the dimensions of cost, quality, and availability. As was explained in an chapter four, in this study, local sourcing has been linked to outsourcing from small and medium-sized suppliers because of the structure of the components sub-sector in Kenya currently predominately populated by small and medium-sized firms (Masai, 1991). Hence, by examining factors which influence local sourcing, 'inferences' can be made about the potential for local sourcing from local SMEs.

**Table 8-2**      *Locally Sourced Items<sup>1</sup> - Assemblers and Selected Franchise holders*  
**(1992/1993)**

ITEM	GMK	AVA	KVM	MARS HALLS	TOYOTA	CMC	DOBIE
1. Oils	x	x	x	x	x	x	x
2. Greases	x	x	x	x	x	x	x
3. Fuels	x	x	x	x	x	x	x
4. Brake and Clutch Fluid	x	a	a	x	x	x	x
5. Sealers	x	x	x	a	a	a	a
6. Adhesives	x	x	x	a	a	a	a
7. Batteries	x	a	a	x	x	x	x
8. Tyres	x	a	a	x	x	x	x
9. Tubes	x	a	a	x	x	x	x
10. Paints	x	x	x	a	a	a	a
11. Toughened flat glass	x	a	a	x	x	x	x
12. Canvas hoods, covers & Screens	a	a	a	a	a	x	a
13. Soft trim and upholstery	x	a	a	a	x	x	x
14. Sound deadening materials	na	a	a	na	na	na	na
15. Radiators	x	a	a	x	x	x	x
16. Exhaust pipes and silencers	x	a	a	na	x	x	x
17. Leaf springs	x	a	a	na	x	x	x
18. Spare wheel carriers	x	a	a	na		x	na
19. Seat Frames	x	a	a	na	x	x	x
20. Wiring Harnesses	x	a	a	x	x	x	x
21. Brake linings	na	a	a	na	na	na	na
22. U-Bolts and U-Bolt Nuts	x	a	a	na	na	x	na
23. Disk Brake Pads	x	a	a	na	x	x	na
24. Hydraulic Dampers & Shocks	x	a	a	x	x	x	na
25. Pre-mixed metal pre-treatment chemicals	x	x	x	a	a	a	a
26. Windscreens, side and rear	x	a	a	x	x	x	x
27. Radio and cassette players	x	a	a	na	x	x	x
28. Hydraulic Jacks & Handles	x	a	a	na	x	x	na

Cont'd

ITEM	GMK	AVA	KVM	MARS HALLS	TOYOTA	CMC	DOBIE
29. Spark Plugs	x	a	a	x	x	x	x
30. Speedometer cables	x	a	a	na	x	x	
31. Disk brake pad backing plates	x	a	a	na	na	x	x
32. Seat belts	x	a	a	na	na	x	na
33. Toolkits	x	a	a	x	x	x	x
34. Airfilters	x	a	a	na	x	x	x
35. Shackle pins for Leafsprings	x	a	a	na	x	x	na
36. Consumables (cleaning materials etc)	na	na	x	na	na	na	na
37. Sanding materials	x	na	na	na	na	na	na
38. Water	na	na	x	na	na	na	na
39. Welding materials	na	x	x	na	a	a	a
40. Rubber bushes and foam strips	na	na	na	na	x	na	na
41. Security serices	na	na	x	na	na	x	x
42. Telephone and telex	na	na	x	na	na	na	na
43. Electricity	na	na	x	na	na	na	na
44. Insurance	na	na	x	na	na	na	na
45. Advertising	x	x	x	x	x	x	x
46. Laundry	na	x	x	x	x	x	x
47. Catering	n	na	na	na	na	na	na
48. Assembly	n	a	a	x	x	x	x

<sup>1</sup> In this study, local sourcing was used as a proxy measure for outsourcing

Note: (i) Local Content figures were available for only one company - GMK

(ii) na - information not available

(iii) a - input or service not procured directly by the company

(iv) x - bought-in item or service

(v) n - provided in-house

**Table 8-3**      *Perceived Factors Influencing Sourcing Activity - Supplier Related*

Cost	Quality	Availability & Reliability
<p>(i) High cost of materials used in manufacture of inputs makes them expensive, hence discourages local sourcing.</p> <p>(ii) High use of imported materials which are perceived to cost more, discourages local sourcing.</p> <p>(iii) Lack of access to foreign exchange by suppliers necessitates the use of 'alternative' markets for funds, making local products more expensive. Hence local sourcing is discouraged.</p> <p>(iv) High duties and taxes make local products more expensive, hence discourage local sourcing.</p> <p>(v) High prices due to low volumes discourage local sourcing.</p>	<p>(i) Technological and managerial capacity of suppliers: Low managerial and technological capacity of suppliers discourages local sourcing, particularly from small firms.</p> <p>(ii) Compatibility of supplier's production equipment and processes with manufacturer's specifications: Low compatibility discourages outsourcing from SMEs</p> <p>(iii) Access to skilled manpower: Due to low profitability levels, small and medium firms employ less skilled workers. The resulting "poor" quality products discourage outsourcing from local SMEs.</p> <p>(iv) Quality control and testing procedures: Poor quality standards discourage local sourcing.</p> <p>(v) Production methods used: Obsolete production approaches lead to poor quality relative to current standards expected by manufacturers. Hence because of perceived "poor" quality of products, local sourcing is discouraged.</p>	<p>(i) Number of suppliers available: Small number of 'good quality' suppliers discourages outsourcing</p> <p>(ii) Capacity of suppliers: low capacity of suppliers, or low capacity use due to lack of working capital discourages outsourcing</p> <p>(iii) Lead-time associated with sourcing: Long lead-time offered by foreign suppliers discourages foreign sourcing, and encourages local sourcing.</p> <p>(iv) Access to foreign exchange: Limited access to foreign exchange for sourcing inputs discourages outsourcing. Foreign funds can be used if internal markets are used.</p> <p>(v) Lack of professionalism by small firms discourages large buyers from using them.</p>

*Source:* Field Notes (1992/1993)



**Table 8-4** *Perceive Factors Influencing Sourcing Activity - Buyer Related*

Quality	Cost	Availability and Reliability
(i) Demands for high quality standards: Perceived low quality of local suppliers and their products discourages local sourcing	<p>(i) Problems of economies of scale: proliferation of makes and models do not allow sufficient volumes. This also prevents specialisation, leading to poor quality products. These discourage local sourcing.</p> <p>(ii) High deletion penalties by manufacturers discourages local sourcing.</p>	<p>(i) Proliferation of makes and models leads to a perception of excessive demands on the capacity of small supplier. Because this affects the quality of local products, it discourages local sourcing.</p> <p>(ii) In order to assure themselves of availability and reliability of resource flows, one supplier has a supplier development programme.</p> <p>(iii) A lack of in-house capacity encourages local sourcing.</p>

*Source:* Field Notes (1992/1993)

**Table 8-5** *Perceived Factors influencing Sourcing Activity - Business Environment Related*

Cost	Quality	Availability and Reliability
<p>(i) Duties and taxes: High duties and taxes discourage local sourcing by making local inputs more expensive.</p> <p>(ii) Cost of raw materials: because of the high cost of local materials required by local suppliers, local sourcing is discouraged.</p>	<p>(i) Legislation affecting acquisition of inputs by suppliers: Mandating for local sourcing encourages local sourcing.</p> <p>(ii) Perceived adverse macro-economic conditions affecting availability of raw materials, finance, technology and skilled manpower to local suppliers discourage local sourcing.</p> <p>(iii) National business culture: Negative attitudes towards local products and services discourage local sourcing.</p> <p>(iv) National business culture: Negative attitudes towards the products of small and medium-sized firms discourage local sourcing.</p>	<p>(i) Lack of foreign exchange for the procurement of CKDs and inputs for locally sourced parts and components</p> <p>(ii) Non-tariff restrictions to importation of some components.</p>

*Source:* Field Notes (1992/1993)

*Tables 8-3 to 8-5* above outline some of the main findings of the research. Four pre-conditions for inter-firm relations are apparent. First, the buying firm must have the ability to dis-aggregate, predicated on various reasons for dis-aggregation or use of external sources (for example, the lack of internal capacity, the need to access resources and markets, etc.). Secondly, also important are the buyer's perceptions about the availability of suitable suppliers, particularly their ability to meet their quality, price and delivery requirements. These are influenced, in turn, by suppliers' technological and managerial capabilities to access and process resources and manpower to meet the needs of the buyer. Thirdly, according to Harrigan and Newmann (1990), inter-firm linkages are predicated on factors in the environment which condition the extent to which the buyers and sellers perceive the need to form linkages. These include those legislative and regulatory conditions which make it necessary to form such linkages, in this case, specific mandatory local sourcing required by the government; macro- issues which limit the growth of local suppliers; availability of skilled manpower; and regulations restricting the free flow of resources such as foreign exchange.

*Tables 8-3 to 8-5* present the factors as those discouraging local sourcing in prevailing circumstances, with a particular emphasis on the link between local sourcing and SMEs. The same factors encourage local sourcing within different contexts. For example, model proliferation and market fragmentation have been argued to be the main stimulants for large firm fragmentation in the context of the vehicle industries of developed economies (Hoffman and Kaplinsky, 1988). In addition, it is clear that many of these factors are attitudinal. This implies that in order to promote inter-firm linkages their removal, or reversal of the processes by which these negative attitudes are created, should encourage local sourcing.

Such findings have several practical and theoretical implications. Overall, the findings indicate that 'necessity' is the dominant motive for any inter-firm linkage formation. Consequently, only mandated items are outsourced, although an unexpectedly high proportion of these is sourced from SMEs. However, other findings which further throw light on this finding follow. First, they refute the suggestion of the primacy of cost efficiency as suggested by Williamson (1975), in the formation of inter-firm relationships. In this case, inter-firm relations are used for reasons of necessity (Whetten, 1981). The findings also indicate that firms seek to stabilise their business environment to some extent by integrating, essentially to reduce the number of competitors in this environment. This is not surprising since business environments in developing countries have a high element of uncertainty, in addition to extreme scarcity of resources. It can be inferred from this discussion that where resources are scarce, stabilisation is achieved through integration rather than through inter-firm linkages. This contradicts Pfeffer and Salancik's (1978) view that inter-firm relations are used to stabilise the business environment.

Secondly, other motivations for inter-firm linkages were evident in this study. As noted in chapter seven, for example, GMK has a supplier development programme developed at headquarters. Consequently, it was responding to corporate policy rather than to immediate commercial considerations to use local suppliers. It can be argued, therefore, that corporate policy plays an important role in GMK's sourcing behaviour, but as noted above, this could be short-lived since corporate policy at headquarters is determined by factors largely beyond the control of their branches.

Thirdly, although it does not come out explicitly in the interviews, there are possibilities that the assemblers are using local suppliers as a secondary motive to achieve legitimacy (DiMaggio, 1988). Since the Kenyan Government launched its *Jua kali* development programme, large firms have made efforts to contribute to the process, ostensibly, in order to contribute to industrialisation. However, sceptics may argue that this is but one way of ensuring that the government allocates resources to those who are seen to be contributing to its goals. However, as mentioned, this was not specifically captured in the study. It would be interesting to establish how much of current inter-firm relations is attributable to this motive, and the nature of the power distribution in the relationship.

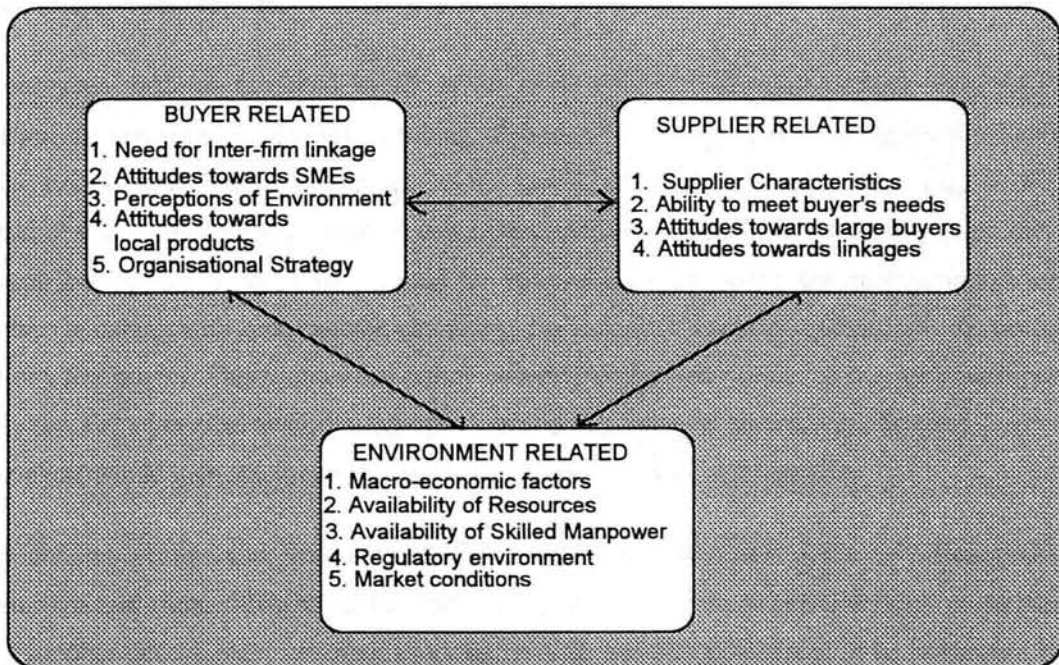
Finally, it is evident that a large number of the factors influencing the limited sourcing behaviour of the assemblers are attitudinal. This implies that it is the perceptions of the buyer which are important in initiating or continuing an inter-firm relationship. Consequently, theories which examine the external factors which explain inter-firm relationships are inappropriately focused on such factors, when in fact, it is the internal sourcing strategies of buyers which influence the formation of inter-firm linkages.

Figure 8-2 presents some tentative suggestions about the perceived factors affecting inter-firm linkages in the Kenyan context. Clearly, many of the factors presented in *fig. 8-2* represent the perceptions of management about the conditions affecting their sourcing choices, and the process by which they search for solutions to their procurement challenges. As was stated in the introduction to this thesis, the perceptions of management about the feasibility of inter-firm relationships as an alternative procurement arrangement are critical in determining whether such relationships can be developed in a particular environment.

#### **8.4 BUYER-SUPPLIER RELATIONS IN KENYA'S MOTOR INDUSTRY**

The nature of buyer-supplier relations is an indicator of whether buyers can 'support' small suppliers. As reported earlier (in chapter 4) Sako (1992) identified two contractual patterns - Arm's Length Contractual Relations (ACR) which she associates with buyer-supplier relations in Britain, and Obligational Contractual Relations (OCR) which she associates with Japanese buyer supplier

relations. ACR relations, because of their arms length treatment of the supplier, do not encourage SME development through buyer support. The study reported here found that buyer-supplier relations in the Kenyan motor vehicle industry are generally ACR, although GMK exhibited a less extreme variant of these relations. For example, all the assemblers and importers/distributors studied reported that they preferred to retain more than one supplier for each item as an assurance against excessive bargaining power by suppliers. In practice, however, two of the importer/distributors retained only one supplier in over 60% of the items outsourced, arguing that the scarcity of good quality suppliers made it difficult to find more than one supplier who could meet their needs.



*Fig. 8-2 Factors Influencing Inter-firm Linkages in Kenya's Motor Industry.*

A second demonstration of ACR relations within the sector is the low level of information exchange during the life of an order (Sako, 1992). This means that suppliers only have information pertinent to the order (specifications and standards), and little, if any, information about the general organisation of each other's production and administrative processes. According to Sako (1992) this reduces the level of trust, and has potential for opportunistic behaviour by either party.

Arguably, therefore, this buyer-supplier relations environment does not provide opportunities for 'voluntary' outsourcing by buyers. Additionally, because buyers and sellers are seeking profitability individually, they act in self interest, hence changing suppliers at will to maintain



bargaining power, or indeed sourcing from foreign suppliers, becomes appealing if there are no obligations between the parties. A lack of supplier development activities in all the cases, with the exception of GMK, implies that there is no motivation to 'nurture' local suppliers.

Consequently, supplier development activities were found to be limited. GMK was the only assembler with a specific supplier development policy. It would appear that this is related to the way GMK is organised for production. It is the only assembler which makes sourcing decisions both as an assembler and importer. None of the importer/distributor companies associated with KVM and AVA have supplier development activities either. The only supplier development activity that may be inferred from the case studies is the transfer of technology through blueprints and training provided by the manufacturer. One possible explanation is the arms-length nature of their association with suppliers.

The contractual patterns exhibited by all of the cases studied further demonstrate their ACR orientation, demonstrated by multiple sourcing, absence of long-term contractual agreements, and a limited exchange of communication beyond the specifications of a particular order. Expectedly, this kind of framework introduces high levels of uncertainty for suppliers, particularly when they are dependent on the buyer. SMEs would be vulnerable in the sense that they would have difficulties in coping with such extreme variability, particularly if assets are dedicated to the needs of one or a few buyers. This implies that policy intended to stimulate local sourcing has to address these issues. On a practical level, for example, specific requirements for contracts between buyers and suppliers would help ameliorate the uncertainty for both buyers and suppliers.

This discussion confirms that firms act in self interest and only take those decisions which assure them survival and competitiveness in the short-run. In two of the case studies discussed in chapter seven, supplier development was seen as an added cost, and thus considered to be managerially unsound in the short-run. Interestingly, it is the uncertainty of the political and economic environments which were cited as the causes of this short-termist behaviour. This short-termism is reflected, not surprisingly, in the buyer-supplier relations. In two of the cases, an element of opportunism is also reported.

Again this has important implications for policy. Stability and the relative certainty of the business and political environments are key factors in the use and development of SMEs by large buyers. Uncertain environments elicit defensive behaviour.

## **8.5 FORMING INTER-FIRM RELATIONSHIPS WITH SMES**

As stated previously (chapters 1-5), the prospects of large firms forming inter-firm linkages with small firms is predicated on the large firm's propensity to form linkages with other firms,



particularly with small firms. This, it was argued, is predicated on their motivation to use small firms as suppliers or partners. From the research, it is evident that one of the critical factors influencing inter-firm linkages in the sector is the buyers' attitude towards the suppliers in terms of their ability to meet (buyers') requirements. This refers to buyer perceptions of supplier characteristics and the ability of these to satisfy the buyers' needs. Several issues become apparent from the case studies presented in chapter seven about buyer preferences of supplier characteristics. First, buyers are interested in quality suppliers regardless of size. This is defined as those suppliers who can deliver acceptable quality, competitively and reliably. This confirms the contention of the vertical integration literature that firms integrate vertically because of perceived market failure brought about by, among other things, 'unacceptable' suppliers.

However, the finding that on average, approximately 65% of the suppliers to the sector can be categorised as small or medium firms suggests that there are other factors influencing large firm local sourcing behaviour. This relatively large proportion of SME suppliers contradicts expectations that large buyers will be reluctant to transact with small firms because of their perceived and reported "poor quality, unreliability, and lack of professionalism" as discussed in chapter four. The study reveals that buyers do perceive suppliers to be of low quality, with incompatible and incongruent technologies and production modes. However, this does not correspond with the subsequent finding that despite these weaknesses, there seems to be a more use of small and medium suppliers than large ones. Arguably, therefore, the quality of suppliers does not present the whole picture here. Two other factors were found to impact on this high level of use of small and medium suppliers. First, as already discussed in chapter seven, the firms in the study use small and medium firms because of compulsory local sourcing. Secondly, against this background, small and medium small firms are used because buyers are faced with a market where there are only a few suppliers in many components and parts sub-sectors, and because of the fragmented small markets, these tend to be the small and medium sized firms.

Hence, this finding suggests that the structure of an industry is important in the formation and use of inter-firm linkages. A small number of suppliers limits the extent to which large firms can exploit the opportunities to dis-aggregate and use external suppliers because of the lack of alternatives. Secondly, it suggests that the lack of flexibility in large firms themselves limits the extent to which they select strategies such as inter-firm linkages. Flexible specialisation theories argue that the basis of using inter-firm linkages is their search for flexibility, hence the use of small and medium firms which themselves are flexible enough to cope with variety, or allow the large firm to introduce flexibility into its own schedule by 'buying-in' capacity, technology and skills. Finally, this finding suggests that a fragmented consumer market does not necessarily lead to externalisation, or indeed, to the use of small and medium firms. In the case studies presented in

chapter seven, large firms have been shown to be reluctant to deal with local small suppliers due to perceived weaknesses arising from market fragmentation.

#### **8.6 BUYER PERCEPTIONS OF SMEs AND BUYER PREFERENCES OF SUPPLIER CHARACTERISTICS**

From the cases, it is evident that buyer perceptions of SMEs significantly impact on sourcing from such SMEs. In all the cases, it was reported that in principle, large buyers have no prejudice against SMEs. However, in practice, SMEs in Kenya do not appear to possess the managerial and technological capacity to provide the quality required by the industry. This means that according to large firm decision makers, it is the weaknesses of the SMEs themselves that are problematic to the promotion of linkages with large firms. Arguably, this is a one sided view from the large firms' perspective, but it is, nevertheless, the buyer's perceptions of potential suppliers that are critical in developing linkages between large and small firms. As was argued in chapter three, sourcing decisions are largely based on the buyer's interpretation of the ability of the potential and existing suppliers to meet their requirements. Hence, if the buyer perceives that existing suppliers cannot meet their requirements, the tendency will be to vertically integrate or to use alternative sources. It is important to note that this has little to do with the 'reality' of supplier suitability, but rather a question of perception and attitude. Theories which aim to develop frameworks for SME development through this vehicle have, therefore, to take buyer perceptions and attitudes seriously, while practical programmes aimed at developing SMEs through strategic alliances, joint ventures, or sub-contracting forms of linkages with large firms need to address the specific perceived problems. For example, it is unlikely that any programmes which aim to develop such linkages will succeed if large buyers do not perceive that the quality, cost and delivery targets they set in their organisations can be met by local suppliers.

#### **8.7 SUMMARY AND CONCLUSION**

This chapter has attempted to bring together the findings reported in chapter seven, discussing their implications. It has been argued that currently, under existing politico-economic arrangements, despite the amenability of production organisation to outsourcing, there are limited prospects for SME development through linkages with large firms in Kenya's motor vehicle industry. First, outsourcing by large firms is limited to mandated items, and existing arrangements discourage further outsourcing. In the absence of mandates, large firms would prefer to source from suppliers overseas as these are perceived to offer better quality products. Consequently, it would appear that the received models explaining inter-firm relationship formation take for granted that the market is efficient, allowing the assumption that decision-makers are confronted only with the choice between alternatives of production organisation. It has emerged, for example,

that local sourcing, and hence sourcing from local small firms is predicated on coercive legislation. An interesting 'political' dimension is thus introduced. Secondly, opportunities for various types of linkages with SMEs exist, but these are currently attributed to the somewhat negative factor of lack of alternative suppliers for many items. In the long run, this will not sustain small-large firm linkages as there is potential for sourcing from alternative sources when opportunities present themselves. For example, removing legislated sourcing requirements could mean that overseas sources could be used. Indeed, anecdotal evidence was given by an industry observer, that importers have frequently used 'loopholes' in the regulatory system to obtain No Objection Certificates to source from overseas.

Various factors discouraging or encouraging local sourcing were identified. These fall into three broad categories: factors related to the macro-environment within which the firms are operating, the most critical being government influences; factors (as perceived by the large buyers) relating to the nature and behaviour of the local suppliers, many of whom are small and medium-sized firm; factors relating to the buyers themselves. It is clear that most of these factors relate to the limited number of suppliers in the sector, and the perceived 'weakness' of the supplier base. However, opportunities do exist. Buyers are, in principal, willing to buy from SMEs, although their reasons for using local small firms have limited prospects for increased transactions between large and small firms. Policy must focus, therefore, on the removal of these impediments, and on changing the perceptions of SMEs held by large buyers.

The chapter also discusses the buyer-supplier relations within the sector, arguing that their distinctively ACR nature discourages inter-firm relations in general and does not provide the opportunity for supplier development. If inter-firm relationships are to be used as a vehicle for SME development, large firms 'must' have the motivation to develop, at least, their small and medium suppliers. In the prevailing business climate, however, where buyers are concerned with short-term profits, supplier development is considered to be an unwanted cost.

Under such circumstances it seems unlikely that large firms will source from these firms, or transfer technology and skills to them. Thus, few inter-firm linkages with SMEs can be expected, and the development of the indigenous small firm sector of the economy through formation of large-small firm linkages seem to have limited practical applicability in a country such as Kenya. However, there is evidence from the case studies that the Kenya vehicle assembly firms will source locally, and from small and medium-sized enterprises, if mandated to do so. While further legal mandating may be deemed, currently, to be the only practical strategy for promoting linkages, it may be necessary for the government to work with the Kenyan motor vehicle industry to develop a programme of incentives which will encourage both the use of local small business suppliers and their technological and commercial development. Clearly, it is in the long-term

interests of both the motor vehicle industry in Kenya and the government to ensure the growth of local small firm suppliers in order to benefit from the current global motor vehicle industry restructuring encapsulated in the processes of flexible specialisation or lean production (see chapters 2, 3 and 4) and the development of a strengthened local economy. At the same time, however, care must be taken to ensure that the country's small firms do not become over-dependent on any one client or market sector. However, although currently, the structure of the supplier base described in the case studies does not appear to be a problem since most suppliers serve more than one client, and all of the firms studied are reluctant to be dependent on one supplier, there is potential for collusion by the clients since they are few in number.

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## CHAPTER NINE

### SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

This chapter summarises the study and presents some major conclusions of the research. It also presents some theoretical and policy recommendations for promoting large-small firm linkages in Kenya, and indeed, other developing countries, and considers the theoretical implications of the findings.

#### 9.1 SUMMARY

The research aimed to explore the prospects for SME development through linkages with large firms in Kenya by exploring the production organisation and sourcing strategies of large firms in the country's motor vehicle industry. It has been argued in the thesis that despite the positive experiences of countries which have used the complementarity of large and small firms in their industrialisation, few developing countries have used this as a deliberate strategy for SME development. Kenya falls within this latter category. It has also been argued that in the particular case of Kenya, because of the historical emphasis by policy makers on large firms, SMEs have continued to remain weak and unable to support the needs of large firms in industry. It was argued, therefore, that in order to take advantage of the potential of the complementarity between large and small firms, a linkage strategy is expedient. Yet, there is limited knowledge about how to motivate large firms to form linkages with SMEs as suppliers. It was argued in chapter five, as does Masai (1991), that like other developing countries ridden by infrastructural problems, large firms in Kenya are likely to have limited linkages with small firms, mainly due to the perceived weaknesses of the small firms themselves as suppliers of components and services. It was important, therefore, to understand how large firms organise themselves for production, and whether this organisation offers any prospects for small enterprise development through inter-firm linkages such as sub-contracting, joint ventures or strategic alliances. It entails, therefore, examining their sourcing strategies and the motivations behind them as an indicator of the possibility of future use of similar strategies.

From a review of the literature addressing the issue of inter-firm linkage formation, it was determined that theories which abstract from efficiency paradigms, such as those suggested by Williamson (1975) and Porter (1985) provide important, but not sufficient explanations for the choice by large firms to buy from small firms in Kenya. This research suggests that while keeping

cost considerations in mind, the motivation behind the large firm's sourcing strategies is a combination of the pursuit of market power through distinctive access to quality products, and the need to comply with legal requirements, essentially as an assurance against exclusion from participating in the economy. Hence, inter-firm relations have been hypothesised to be determined by the extent to which buyers perceive that they can access markets and resources. In other words, the extent to which they perceive the existence of suitable suppliers for their needs.

In order to address the research problem, a case study approach was adopted. The sourcing behaviour and inter-firm relations of the three large Kenyan vehicle assemblers and four of their constituent 'importers' were studied. In-depth interviews were conducted using interview guides containing open-ended questions. The data was analysed using qualitative approaches. The research is based on the thesis that in order to promote large firm-small firm linkages, it is critical to understand the factors which influence the sourcing behaviour of large firms. Hence, the case studies were structured around the sourcing activities of the assemblers, and their constituent 'importers', who hold the franchises for the importation of CKD kits in Kenya. Local sourcing was used as a surrogate measure of outsourcing on the grounds that Kenya does not have local vehicle manufacturing capacity. An important extension related to the thesis of this research is that local firms in the components sector tend to be small or medium sized firms (Masai, 1991), hence, suggesting a relationship between local sourcing in the motor vehicle industry and the use of small and medium sized firms as suppliers. A concomitant dimension involved the analysis of the general buyer-supplier relations within the sector, which helps to contextualise the reluctance of large buyers to outsource. It is also within this context that the study was extended to examine large firm attitudes towards small suppliers, and the prospects for linkage formation at this level. The resulting findings are presented as case studies in chapter seven and eight of this thesis.

## 9.2 MAJOR FINDINGS AND CONCLUSIONS

In conceiving this study, assumptions were made that a size distribution of production between large and small firms in Kenya would contribute to the alleviation of the current economic crisis, and to the development of SMEs. Based on the positive experiences of Japan, South East Asia, Germany and others, it was further assumed that this distribution could be achieved through the promotion of inter-firm linkages within all industries. It is further suggested that Kenya could benefit from the local sourcing activities of existing firms, as one strategy towards the development of a local (indigenous?) manufacturing sector. However, as argued by authors such as Masai (1991) and Coughlin (1991), and also from anecdotal and experiential evidence, it was assumed that there is a problem in developing inter-firm linkages of all types between large and small firms in Kenya.

Two questions were pertinent in investigating this problem: Do large firms in Kenya's motor vehicle industry, through external sourcing activities, offer any prospects for SME development? As already mentioned, it was argued that this question could be addressed by examining the sourcing behaviour of large firms, particularly sub-contracting. It was particularly important to understand the motivations behind sourcing behaviour, and how these affect decisions about inter-firm linkages. This led to the second question: What factors influence their sourcing behaviour, and do these offer opportunities for SME development? This involved the analysis of the factors influencing managerial choices to source from local SME firms, and large buyer's attitudes towards SMEs as suppliers.

The emergent picture from the research confirms expectations. Overall, the study lends support to the argument that for various reasons, largely related to market failure, and the limited potential for exploiting scale economies due to limited markets, large firms in Kenya's motor vehicle industry are reluctant to outsource 'voluntarily' from local small firms. Consequently, given the prevailing conditions in the business environment, and despite the amenability of the vehicle assembly industry to production organisation dis-aggregation, prospects for SME development through linkages with large firms are minimal. Whatever outsourcing exists (mainly sub-contracting of components) is stimulated by legislation, and even then, efforts are made to use alternative sources, for example, foreign suppliers. This seems to support Doner's (1993) analysis of the effect of mandating on local sourcing in some South East Asian countries. However, this research also found that the extent to which such mandating precipitates voluntary local sourcing is limited. It is doubtful, therefore, whether mandating alone will stimulate local sourcing, or indeed, linkages between large and small firms. It has to be accompanied by schemes which facilitate expansion of the domestic car market, and at the same time initiating export schemes. In addition, the process by which CKDs are compiled has an effect on the adoption of local sourcing strategies. It was highlighted in the findings in chapter seven that one of the most important factors limiting local sourcing is the deletion penalty imposed by the manufacturers of CKDs. This implies that Kenya as a country has little control, if any, on the industry's activities, and local assemblers are largely responding to decisions made by the principal manufacturers. This brings to question how realistic a recommendation for local sourcing is in the prevailing environment. Countries such as Korea and Taiwan have used the logic of economic nationalism to justify localisation even if initially, they found few economic advantages for doing so (Donner, 1991).

items. Hence, access implies competitive advantage. Compliance is viewed, therefore, within the framework of accessing future resources over which the government has a significant control. Consequently, the outsourcing activities in the sector are limited to those items mandated.

In addition, despite reporting an indifference to the size of their supplier, large firms in the motor vehicle industry perceive Kenya's small and medium-sized enterprises in the components industry to be of poor quality and unreliable. By reference to the analysis of the manufacturing industry presented in chapter five, in prevailing business circumstances, it is unlikely that this desired level of quality will be found in small and medium firms in Kenya. This scenario suggests that outsourcing from small firms is limited by perceived market failure brought about by a perceived absence of 'quality' suppliers. Quality suppliers were defined by the respondents as those suppliers who could supply quality, competitively priced components or services in good time, all the time. In other words, quality and reliability were of primary concern. Cost considerations were reported to be secondary. This generally agrees with the vertical integration literature which posits that firms adjust to market failure by integrating. On the other hand, it negates Williamson's (1975) proposal of the primacy of cost in sourcing decisions, and suggests that instead, firms are motivated by a combination of factors including the need to comply with government regulations as an assurance of access to licenses and foreign exchange allocations.

A second emergent picture is that buyer-supplier relations are distinctively arms-length, with little or no supplier development activity in the sector. This short-termist orientation affects the buyer's attitude towards suppliers. It is difficult, therefore, to envisage large firm support of small enterprises as a strategy for increasing the supply of good 'quality' suppliers, thus limiting the extent to which the perceived market failure can be alleviated by the private sector itself. Secondly, it offers little opportunity for SME development through technology transfer and training.

### **9.3 IMPLICATIONS OF FINDINGS AND CONCLUSIONS**

The implications of the research fall into two broad categories: those relating to theory; and those relating to the practical problem of promoting linkages between large and small firms in Kenya, and developing countries in general.

#### **9.3.1. IMPLICATIONS FOR THEORY**

This research was conceived in view of the current global trends in industrial development where fragmentation and inter-firm relationships are used as a strategy for organisational and national competitiveness. This approach argues that as firms respond to environmental pressures, they are adopting downsizing strategies (lean production) in order to achieve efficiency. This study reveals that this process is not as obvious in Kenya's motor vehicle industry. Firms are reluctant to use



external sources of supply. They continue to obtain a large proportion of their requirements from their sister companies. Additionally, they procure their CKD kits from principle suppliers, based on the argument of lack of supply in the local environment. Consequently, it can be argued that the existence of sources of supply play an important role in encouraging inter-firm relations. This implies that prospects for inter-firm relationship formation are currently limited. By extension, the related benefits of dis-aggregation such as flexibility of labour and production are limited. This supports Kaplinsky and Posthuma's (1993) finding regarding the limited adoption of JIT techniques in developing countries.

The study also reveals that large firms outsource in response to government mandating rather than to purely rational economic decisions. This contradicts two elements of the literature. First, it contradicts the literature which suggests that firms form inter-firm linkages as an outcome of economic considerations of efficiency and effectiveness. The study supports, therefore, the alternative contention that other motivations influence the use of inter-firm relationships. Consequently, in designing inter-firm relationship promotion programmes, it is critical to include other possible influencing factors such as the effect of legislation which mandates external sourcing or control of vertical integration, or requires firms to use inter-firm linkages. Secondly, it contradicts the primacy of cost minimisation advocated by students of transaction cost theory. It was found that other factors motivate inter-firm linkage formation, in this case, the desire to comply with government regulation as an assurance against being denied access to resources and markets. Consequently, strategies for the promotion of SMEs must consider the extent to which firms perceive inter-firm relationships as 'necessary' rather than as a rational, economic consideration about cost minimisation. This finding also suggests that firms form inter-firm linkages because of a combination of reasons. This contradicts the generic inter-firm relationship theory which analyses the various motivations separately, and supports Oliver's (1990) contention that there is need to rethink approaches to inter-firm relationship theorisation. Further research is a needed, therefore, to establish the inter-relationship between the various motivations, and also the relative importance of each one to company decisions.

Another implication for theory suggests that the limited inter-firm relationships observed in the Kenyan motor vehicle industry can be attributed to attitudinal issues which impact on managerial sourcing decisions. For example, the perception that local suppliers are of relatively poor quality and unable to supply required quantities has implications for the supplier search process, generally tending to overlook local possibilities. It is also possible that due to this attitudinal orientation, large firms are even less likely to use small local firms. This finding supports the *a priori* assumption made by the study that in order to understand inter-firm linkage formation, it is critical to analyse the large firm's propensity and motivation to form linkages with small local suppliers.



However, it seems that in order to promote linkages between large and small firms, four pre-conditions are critical: the ability of the large firm to dis-aggregate, based on its motivations to do so; its motivation to use external suppliers; its attitudes towards using SMEs as suppliers; and its perception about the business environment, particularly that regarding the regulatory and economic environments. Consequently, strategies which aim to promote inter-firm linkages must focus on the large firms' motivations towards suppliers, rather than focus on external factors. This approach is useful in arguing, for example, that vertical integration and internal transfers are stimulated by a firm's perception of the efficiency of input markets. Hence, market efficiency encourages inter-firm linkages, while market failure contributes to vertical integration. Strategies which remove those factors which lead to market failure are considered, therefore, to be appropriate for promoting linkages.

Finally, this study suggests that while there appear to be prospects for SME development through linkages with large firms, the pre-conditions for the realisation of this goal are far from clear. Consequently, there is need to test the tentative propositions developed in chapter eight.

### **9.3.2 IMPLICATIONS FOR SME PROMOTION IN DEVELOPING COUNTRIES**

This study contributes towards a framework for analysing and promoting SMEs through linkages between small and large firms by highlighting the role of legislation in the promotion of inter-firm linkages in a developing country context.

The study also supports the assumption that there are prospects for inter-firm linkages in developing country contexts, although these have to be deliberately promoted by developing a specific policy which addresses current impediments to their promotion. It suggests that in a developing country context, inter-firm relationships are less likely to be used 'voluntarily' by large firms as their attitude towards local inputs is negative. It also implies that this negative attitude is a function of the large firms' perception of market inefficiency - the ability of existing suppliers, if any, to supply required inputs in required quantities, at appropriate prices.

Secondly, it highlights the role of the state in promoting linkages between large and small firms. The study's revelation that large firms outsource only mandated items implies that other incentives (alternatives) are not immediately available to managers in the sector. For example, all the firms in the study argued that they were prevented from using local suppliers by the weaknesses they perceive in the supplier base.

### 9.3.3 IMPLICATIONS FOR SME PROMOTION IN KENYA

The study reported here confirms the widely held view, in Kenya, that the negative attitude of large firms towards small local suppliers limits the prospects for linkages. These predominately attitudinal explanations to the limited use of inter-firm linkages include doubts about the quality of local products. While the objectivity of these contentions was not tested in this study, it is important to consider their impact on the use of local suppliers. It was argued earlier that it is the perceptions and managerial decisions made by large firms that influence industry behaviour. Consequently, strategies which aim to promote large firm-small firm linkages must take the motivations of these firms seriously. Such strategies will have to address the 'weaknesses' attributed to the local inputs markets, while simultaneously encouraging large buyers to use those inputs available, and to develop those not available in conjunction with small local suppliers. Evidence presented in chapters seven and eight suggests that these weaknesses are related, largely, to the nature and impact of the macro-environment. Hence, this approach requires government support in terms of resources, and a conducive environment.

Secondly, the study found that mandating generates some inter-firm relationship formation. This implies that firms are concerned about their relationship with the state, and the effect of the state on their access to resources and markets. This confirms the literature on managing in developing countries which suggests that the role of the state in determining the business environment is critical. This finding can be used to advantage by the government by using selective regulatory measures which address the particular deficiencies in large firm behaviour. For example, selective import restrictions could help encourage the development of some input sectors with a view to encouraging local supplier development. In addition, such import restriction could prevent the 'collapse' of strategic industries, such as the vehicle assembly industry. However, this strategy would need to be accompanied by specific incentives to ameliorate the effects of reduced competition in domestic markets.

Finally, it was found that AVA and KVM, whose model of production organisation includes constituent importers/distributors, do not have a specific supplier development programme, use multiple sources of suppliers for their requirements, and do not encourage long-term relations with suppliers. This short-termist approach to industrial organisation is, arguably, the result of the lack of economic incentives within the industry for firms to seek long-term benefits from their production organisation strategies. Strategies which aim to develop SMEs through linkages, therefore, have to address this problem, mainly by developing cohesive long-range industrialisation policies which encourage long-range perspectives by managers. Currently, the frequent market failure and uncertainties in the business environment encourage opportunistic behaviour by both buyers and suppliers.

### 9.3.4 IMPLICATIONS FOR KENYA'S MOTOR VEHICLE INDUSTRY

Finally, there are implications for the motor vehicle industry in particular. This study has re-stated empirically the suggestion made by Masai (1991) and others that vehicle assemblers make limited use of local small suppliers for their input needs. It also helps to clarify some issues about Kenya's motor vehicle industry.

The study reveals that based on the number of makes and models assembled by each assembler, the Kenyan vehicle market is heavily fragmented. In industrialised countries, this fragmentation is argued to be the basis for large firm dis-aggregation and the use of smaller units of production in search of flexibility. In Kenya, however, this was found to contribute significantly to the perceived 'undesirability' of local suppliers. On the one hand, the components sub-sector was viewed as 'weak' and unable to meet the demands of the assembly sub-sector. On the other hand, the components sub-sector was set up earlier than the assembly sub-sector and might be expected to have developed adequately to serve the needs of the sector. Hence, this finding has two implications: that the supplier market has not developed at the rate expected to meet the needs of a growing vehicle assembly sector, or that managers are not objective about their assessment of the supplier alternatives.

If the first case is indeed 'true', then strategies which aim to develop the motor vehicle industry, or indeed manufacturing industry in general, must first examine the reasons for the failure of local firms to 'grow' and acquire their capabilities to provide high quality products to buyers. For example, issues of access to technology, finance, foreign exchange, and skilled manpower, which have been argued by large firms in this study to limit their use of local suppliers, have to be addressed in order to facilitate the growth of a 'sophisticated' local supplier base. In addition, standardisation of parts and components through rationalisation of makes and models could increase specialisation, and perhaps allow some firms to achieve economies of scale at plant level.

If, on the other hand, the second case is 'true', then strategies which seek to change large firms attitudes towards small firms are required. This may be accomplished by adopting the strategies outlined in the preceding paragraphs to 'improve' the attractiveness of small local suppliers. It may also be accomplished by presenting large buyers with the incentives to use local supplier rather than overseas suppliers, or indeed internal transfers. One approach is to increase the relative cost competitiveness of local firms through tariffs on imports.

## 9.4 LIMITATIONS OF THE STUDY

### 9.4.1 PROBLEMS OF CONCEPTUALISING THE RESEARCH ISSUES

The research problem concerns the understanding of how inter-firm relationships are formed between large and small firms. The vast body of literature available 'explains' linkage formation as an outcome of structural dis-aggregation by organisations. Yet, the actual social process of linkage formation is equally important. A more powerful approach than that used in this study would have been to establish, first, the relationship between organisational dis-aggregation, and the politico-social process of inter-firm linkage formation. Given the time limitations, this study did not pursue this strategy. In addition to the general lack of knowledge about linkage formation between large and small firms, it was difficult to conceptualise the research issues

This led to the general problem of identifying and defining the concepts to be studied. In an attempt to avoid the 'slavish' use of concepts, the cross-case approach was used to analyse the data collected. Obviously, this does not satisfy the critics of the case study approach. Having said that, it is believed that the empirical exploration exercise has resulted in a number of valuable findings. Chapter eight outlines the results of this exercise.

### 9.4.2 METHODOLOGY AND RESEARCH DESIGN

This study has not reviewed the SME perspective. By this omission, the research is conspicuously lacking in balance of opinion. In chapter one, it was stated that for various reasons, the emphasis of this study would be on the large firm (buyer). Consequently, the analysis of the suppliers was considered to be an integral part of the study despite the particular focus on the buyer. A third phase of the study was, therefore, to pursue this line of enquiry. However, an early focusing of the study was required. This was achieved by pursuing the sourcing strategies of large firms, and then pursuing their specific suppliers. This starting point is considered by the author to offer the first building blocks to what appears to be a complex research agenda.

Two outcomes of the effort to include the SME supplier firms discouraged further activity along these lines: out of the thirty suppliers identified and targeted, only seven agreed to be interviewed and/or to complete a questionnaire (see copy of questionnaire in Appendix D). Secondly, of the ten questions asked, only four were answered comprehensively, while the most critical questions attempting to find out the extent of linkage with buyers were not answered. Further investigation revealed that as in the case of the large buyers, suppliers in the motor vehicle industry were experiencing the debilitating effects of the recession coupled with extreme industry uncertainty. They were reluctant, therefore, to give indications of the extent of their interaction with their buyers.

It was also clear that because most of these suppliers are small or medium sized, often family owned Asian businesses, full participation in the study would be difficult. Such businesses usually exhibit high levels of secrecy and reticence, particularly when they are not 'familiar' with the person asking questions.

Due to its exploratory nature, the study reported here does not test the hypotheses it suggests. Consequently, it will be necessary to test the various hypotheses and issues raised in the findings, since, due to temporal and resource limitations, these could not be tested within the scope of this PhD. This is suggested as a future line of investigation in section 9.5.2 below.

These methodological limitations suggest that future research in a developing country context must consider them and provide for them if a methodological balance is to be achieved. In addition, future investigations must not underestimate the logistical and operational difficulties of conducting research in a developing country such as Kenya. Political, social, economic and cultural factors invalidate many of the 'tried and tested' approaches taken for granted in developed economies (Austin, 1990). For example, it was difficult to obtain responses about future industry behaviour as respondents were uncertain about the outcome of ongoing political changes in the country at the time of the study.

Finally, it is clear that survey data would have been useful in augmenting the case study methodology, not as a way of 'supporting' the qualitative data, but as a way of establishing general trends at industry and sub-sector levels (Miles and Huberman, 1984). For example, at the commencement of the research, it was not clear what the nature of inter-firm linkages was, or what forms of linkages were more prevalent. It was not appropriate, therefore, to structure the study around particular trends and patterns, or particular forms of inter-firm linkages. While this was eventually found beneficial in that it reduced the bias towards certain forms of such relations, the study had to cast its nets wide by investigating inter-firm linkages in general, rather than say, sub-contracting, strategic alliances or joint ventures as particular forms of inter-firm relationships.

Clearly, this research is not without its limitations. However, it has provided a useful starting point in understanding the nature and motivations for inter-firm linkages in a developing country context such as Kenya, and has provided the foundations for further empirical research. The proposals presented in this thesis need to be tested on a wider scale, both in Kenya and elsewhere.

## 9.5 RECOMMENDATIONS

The recommendations for future actions evolve from the outcomes and limitations of this particular research. Although it is a context specific study, both policy and theoretical recommendations can be made.



### 9.5.1 POLICY RECOMMENDATIONS

The policy recommendations are made relative to the three levels of action envisaged: the government; the large firms (buyers); and the SMEs (suppliers). This strategy is two phased: (i) encourage vertical de-integration by removing those factors which encourage vertical integration; and (ii) encourage linkages by developing an incentive package which addresses the weaknesses of the small enterprise sector, and reduces the negative attitudes of large firms towards small firms.

#### *Recommendations for Government*

This study suggests that what little outsourcing by large firms exists is attributable to compulsory local sourcing requirements. This supports the findings of other studies such as those of the UNIDO Expert Group on the Role and Promotion of Subcontracting in Industrial Development (1969) and Masai (1991). However, it is clear that legislation alone does not lead to 'voluntary' outsourcing or to inter-firm linkages. The issues raised in this study suggest that inter-firm linkage formation is limited by market failure, brought about by the limited number of suppliers who are able to meet the requirements of large buyers. While arguing for limited 'interference' by the state, it is critical that the business environment has adequate economic incentives for firms to outsource from local firms rather than use compulsory sourcing strategies. The government can make the business environment conducive for both small and large firms to seek economic returns through macro-level reforms. For example, foreign exchange and inflationary issues were reported to have adversely affected the competitiveness of local firms relative to foreign suppliers. Consequently, they were reported to be inappropriate by local large buyers. In addition, through specific initiatives such as duty and tax exemptions and other direct assistance for companies sourcing from SMEs, the government can facilitate intrinsically motivated behaviour to outsource from local small firms. As mentioned by Doner (1993), Korea has successfully used strategies such as tax incentives for buyers to encourage voluntary modernisation of small local suppliers through the transfer of technology and managerial know-how. The Kenyan government could also use selective controls on imports, as well as selective subsidies for large firms, as a strategy for stimulating the motivation to use local inputs.

Secondly, the government must put into place a specific and coherent policy framework within which firms can operate as buyers and suppliers. This includes legal reforms which penalise excessive vertical integration while increasing incentives for de-integration and local sourcing. For example, the Monopolies Control and Price Control Commission should be strengthened and equipped to implement the various pieces of legislation which attempt to control concentration of industry. This calls for a transformation of the economy through a competitive policy which recognises the positive stimuli coming from the entry of new producers, and the exit of

established, but less competitive firms. This does not mean that the government should aim to control the growth of the large firms. As Kirby (1984:55) stresses, the relationship between large and small firms should be symbiotic but in order to maximise productivity, both large and small firms must perceive a need for each other. This is not likely to be developed by perpetuating an adversarial relationship between the small and large firms sectors. Rather, efforts must be made through training schemes and other incentives, to encourage large firms to develop small firms voluntarily, a situation which has prevailed in Japan for some time (Sato, 1989).

It is also critical to address the supply side of the equation. Current small enterprise development programmes do not deliberately address the potential of large-small firm linkages. First, such assistance programmes should be aimed specifically at increasing the 'quality' of small firms through resource assistance, in particular, aiming to modernise the sector. Again, the Korean example offers important lessons. Tax incentives have been used as a strategy for the modernisation of small and medium enterprises, in addition to other strategies such as the allocation of financial and foreign exchange resources; promotion of supplier cartels; mandating the frequency of payment of suppliers by buyers; reservation of markets for small and medium firms; and the banning of prime contractors from buying SMEs through stock ownership (Doner, 1993). In this context, specific technology acquisition programmes can be supported through the various assistance organisations, in addition to assisting large firms to transfer technology to small, local suppliers. In addition, management training and capacity building in the various training institutions is critical.

Having said that, it is critical for policy makers to be aware of the finding that owner-assemblers (the GMK 'model') are more likely to link backwards than franchise assemblers (AVA and KVM contractors). By implication, there is need to consider limiting the size, or the decision-making powers of the franchise/importer category.

Secondly, the government must institute legal reforms which remove the impediments which restrict the competitiveness of local small firms. This specifically refers to import restrictions reported to increase the unit price of products. However, this strategy must be implemented with caution as complete liberalisation of some markets could introduce deleterious competition. The components manufacturing sector, although reasonably developed, is not yet sufficiently competitive to accommodate the potential pressures of total liberalisation.

Thirdly, it is necessary to increase the capacity of the Kenya Subcontracting Exchange as a strategy for increasing large firm 'awareness' of the capacity of small local firms. However, the exchange must be seen as a private sector initiative rather than as a government sponsored organisation. One way of organising this would be to use the existing business associations as the

basis for referencing and data collection, especially if such associations have both large and small sized firms as their members.

Finally, the study revealed that SMEs are perceived as weak on a number of criteria, particularly the lack of 'sophisticated' managerial and technological capabilities. It is incumbent upon the government, therefore, to increase the general level of technology and skilled manpower within the business environment. This can be done through the specific promotion of technology-based education and training. Current policies aimed to promote technology development and diffusion should be articulated in specific terms to address the deficiencies of small and medium enterprises, with specific goals which address the deficiency of technology within the country. However, this must be done with careful consideration of the most appropriate technology for the country's needs rather than as an effort to acquire state of the art technology which may not be relevant/appropriate.

A concomitant factor revealed by the study is the deleterious effect of model proliferation. For small firms to develop a 'reasonable' level of skills, it is critical for government planners to control model proliferation through rationalisation policies. One of such policies already used successfully in several of the East Asian countries is a negotiated maximum number of new models introduced within a 'negotiated' period. What this implies is that the government has to agree with importers and assemblers what models are likely to satisfy their commercial and engineering requirements, while delivering an agreed level of wellbeing to the consumer.

The problem of economies of scale might be met through export expansion of both the finished vehicles and the parts and components produced by the small suppliers. Although export promotion schemes exist in the prevailing environment, these are not focussed on particular sectors as a strategy of addressing the sector or sub-sector specific challenges. One possible approach is to encourage small firms in this sub-sector to take advantage of the Export Processing Zones as a way of eliminating the difficulties encountered in accessing importing raw materials. In addition, as is the case with most small firms in Kenya, this inability to access inputs is caused by limited financing. Government assistance should therefore aim at financing the purchase of equipment and other inputs.

### *Recommendations for Large firms*

It was found that although they have the capability and motivation to outsource, large firms generally perceive local firms to be, for various reasons, of a lower than expected 'quality'. However, there is no specific initiative to develop small firms to the quality levels required. Hence, the prospects for linkages with local firms is limited. Large firms should begin to think of their particular industries as a network of inter-dependent sub-networks. Hence, the role of small and

medium enterprises in the large firm's profitability should be conceptualised within the context of the value of the supplier chain. Large firms should, therefore, be encouraged to see small and medium sized firms as part of this wider chain and seek to develop small and medium sized enterprises as if they were an extension of their own chain. Lessons learned from the Japanese exemplar indicate that competitiveness can be achieved collectively through the use of OCR buyer-supplier relationships which encourage supplier development, which is expected to improve the technological and managerial capability of SMEs. As was noted in chapter seven, the three assemblers give limited assistance to their suppliers through order specific blueprints and standards. This way, some technology transfer place takes between large and small firms (buyers to suppliers). It was also reported that some training, guidance and engineering expertise are provided by the large firms. In some cases, buyers were reported to arrange for subcontractors to produce, under license or franchise, from the principal vehicle manufacturers, and a limited amount of quality control was reported. Hence, as a strategy to improve supplier development, large firms must be given the incentive to strengthen these forms of assistance. Clearly, there is need for the government to 'assist' large firms through various incentive schemes as was outlined above under government recommendations.

It is unlikely that given the prevailing conditions, a reasonable number of 'good quality' suppliers will be found in the Kenyan industry. To break the vicious cycle, therefore, large firms have to look to future gains from collaborative inter-firm relations rather than short term profitability (Contractor and Lorange, 1988). This requires both an attitudinal change by managers regarding the potential of small and medium sized firms in Kenya, and a specific organisational policy to develop local small and medium suppliers.

### *Recommendations for Small firms*

Small enterprises have the task of making themselves 'attractive' to large buyers. According to the findings, large firms perceive local suppliers, particularly small and medium sized suppliers, to be of relatively 'poor quality'. Because this is a perceived position, it is important for small firms, together with other participants, to change this perceptions. First, through technology, skills, production processes, and efficiency improvements, they must seek to increase their competitiveness in general.

Secondly, SMEs must actively seek to lobby for legal reforms which remove those impediments to their development. Through Business Associations and other sub-sector specific groupings, small enterprises can consolidate their 'power' to argue for reforms in their business environment.

Thirdly, and perhaps more critically, small firms must reduce their atomisation through clustering, various forms of industrial networks, and other co-operative arrangements (Brusco, 1986), either

as suppliers to large buyers, or as independent competitors in comparable markets. One approach is the business association format. By grouping into industry specific groupings SMEs can address the specific problems related to their industry. A second approach is use of existing trade associations and chambers of commerce as a basis for 'improving' the SME image, particularly with respect to large firms. In addition, such associations can facilitate the development of inter-firm relations between members, particularly if such associations have both large and small firms within their membership. Finally, SMEs can reduce their atomisation through sub-contractor's co-operatives, known in Japan as *Zaibatsu*. Evidence from Japan and the Newly Industrialised Countries (NICs) of South East Asia suggests that firms use such co-operatives in order to increase their bargaining power with buyers, and also as forums for assisting members in other ways. (Friedmann, 1988; Doner, 1993). This assistance includes helping members to enter markets, acquire finance, training, information, joint labour control, joint purchasing and joint manufacturing in cases where a member does not have adequate capacity.

#### 9.5.2 RECOMMENDATIONS FOR FUTURE RESEARCH

At the theoretical level, some hypotheses were advanced in chapter eight. It is critical that further research establishes the extent to which these hold in specific industrial sub-sectors, across the manufacturing industry, and in the industrial structures of other countries of the developing world. Additionally, although compulsory local sourcing accounted for a large proportion of inter-firm relationships found in the organisations under study, the relative importance of this motivation has not been established. It is not clear, for example, whether mandating only led to inter-firm relationships for a period of time, and then changing to other motivational foci.

It was also hypothesised that inter-firm relationship formation between large and small firms are dependent on three categories of factors: those related to the buyer (the large firm); those related to the suppliers (large and small firms); and those related to the nature of the business environment. These hypotheses need to be tested in various settings to establish, for example, the relationship between the various motivations for inter-firm linkages and the levels of their interaction, if any with each other. In addition, detailed studies of specific forms of inter-firm linkages, such as joint ventures, subcontracting, and strategic partnerships, within developing country contexts are required.

Future research might also involve forecasting the direction which inter-firm linkages are likely to take in the Kenya, and developing countries at large, possibly using Delphi forecasting techniques.

As noted above, the main limitation of the study is the lack of a 'balancing' analysis of the suppliers. Taking into consideration possible reluctance of small and medium firms to provide



information, future research should aim to explore the 'objectivity' of the factors raised by the large buyers.

Finally, analysis of the developmental processes of inter-firm formation is the next logical step emanating from this preliminary work. Ring and Van de Ven (1994) argue that inter-firm relationship development is dependent on interpersonal relationships which often supplement formal relationships, and that inter-personal psychological contracts substitute for formal legal contracts. Consequently, the process by which individuals carry these roles forward in order to bind their organisations to form relationships, are important in inter-firm linkage formation. It is critical to explore the extent to which this influences the formation of inter-firm relationships in Kenya. In addition, it is necessary to study the effects of such social factors as prejudice and nepotism on sourcing activities within firms given that the award and management of contracts can be fundamentally governed by social relationships among key participants.

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## APPENDIX E

### MANUFACTURING AND ASSEMBLY AGREEMENT

THIS AGREEMENT is made the \_\_\_\_\_ day of \_\_\_\_\_  
One thousand nine hundred and \_\_\_\_\_ BETWEEN  
British Leyland UK Limited a company incorporated in the United Kingdom  
(hereinafter called "the Licensor" whose registered office is at 174  
Marylebone Road London N.W.1. England AND Leyland Kenya Limited a company  
incorporated in Kenya (hereinafter called "the Licensee") whose principal  
place of business is situate at \_\_\_\_\_

#### WHEREAS

- A. The Licensee has requested the Licensor to permit it to manufacture or have manufactured in the territory hereinafter defined for it certain parts for vehicles excluding proprietary parts and to assemble complete vehicles purchased from the Licensor in complete knockdown (CKD) form incorporating such manufactured Parts and has represented to the Licensor that it has all the necessary facilities therefor
- B. The Licensor agreed to permit such manufacture and assembly on the terms hereinafter appearing

NOW IT IS AGREED as follows:-

#### Definitions:

1. a. In this Agreement where the context so admits - "Vehicles" means such new and unused vehicles as are shown in Schedule 1 and as shall be mutually agreed from time to time PROVIDED ALWAYS that any model or derivative included in the said Schedule 1 shall (unless otherwise determined by the Licensor) cease to be a Vehicle as defined herein whenever the same shall cease to be manufactured and sold by the Licensor in the ordinary course of business.
- b. "Parts" means parts of Vehicles manufactured by or for the Licensor or to its design or specification whether for incorporation in complete Vehicles or for use as replacement parts.



- c. "Proprietary Parts" means parts of Vehicles which are products of manufacturers other than the Licensor or the Licensee being also products not to the design or specification of the Licensor and which are new and unused and which form or are intended to form part of Vehicles.
  - d. "Products" means Vehicles Parts Proprietary Parts and any other parts which form or are intended to form part of Vehicles.
  - e. "Local" where applied to Products means that the same have been manufactured by the Licensee or obtained by the Licensee from sources within the Territory (or other sources approved by the Licensor) other than the Licensor.
  - f. "The Distributor Agreement" shall mean an Agreement between the Licensee and British Leyland Exports Limited a company incorporated in the United Kingdom dated                      day of One thousand nine hundred and                      whereby the Licensee has been appointed distributor for Vehicles and parts on the terms therein contained and any further agreement between the parties in that regard.
  - g. "The Territory" means the territory of The Republic of Kenya.
2. a. During the continuance of this Agreement the Licensee shall have the exclusive right to assemble Vehicles and to manufacture such Parts in The Territory as may be mutually agreed from time to time for inclusion in Vehicles as original equipment and as replacement parts also. The Licensor shall not ( except as otherwise expressly provided for in this Agreement ) assemble or manufacture Vehicles or Parts in The Territory nor grant assembly or manufacturing rights for Vehicles or Parts to any other person firm or company in the Territory.
- b. Unless otherwise agreed in writing by the Licensor the Licensee shall not during the continuance of this Agreement assemble manufacture or distribute or enter into any other arrangement or agreement with any other person firm or company in respect of the design manufacture assembly or distribution of any other automotive products other than Vehicles or be connected with the design manufacture assembly or distribution of such automotive products.

Licence:

- a. Subject to the provisions of this Agreement the Licensor will grant to the Licensee any exclusive licences during the term of this Agreement necessary for the assembly and manufacture in The Territory of Parts that are now or may during the term of this Agreement be the subject of inventions protected by patents under which the Licensor can grant such exclusive licences in The Territory for the purposes of this Agreement.
- b. It shall be the responsibility of the Licensee to obtain all necessary licences for the manufacture of Parts which are protected by patents not owned by the Licensor and for the payments of any royalty in respect thereof but the Licensor will subject to the terms of this Agreement use its reasonable endeavours to facilitate such arrangements.
- c. The Licensee shall not without the written consent of the Licensor grant any sub-licence for the manufacture of Products or for the use of trade marks or model names of the Products nor shall it grant or assign any rights granted to it under or by virtue of this Agreement.

4. Assembly and Manufacture

a. The Licensee shall make available buildings, services, materials and equipment suitable in the opinion of the Licensor for the reception, preparation, manufacture and assembly of Products in accordance with the standards of quality required by the Licensor and as shall be necessary from time to time to fulfil the assembly and manufacturing programmes agreed between the Licensor and the Licensee from time to time.

b. The Licensee shall diligently and skilfully assemble and manufacture Products in accordance with the standards laid down from time to time by the Licensor and the process of assembly and manufacture and the quality and the finish of Products and the state of stocks from time to time shall be open to inspection by the Licensor. The Licensor shall have the right to reject any Product which falls below such standards and the Licensee shall make any modification to such Product or order from the Licensor any Parts, units or parts thereof necessary to bring such Product up to such standards, making payment therefor in accordance with the terms of this Agreement to the extent that such Parts are not covered by Conditions of Warranty set out in Clause 19 hereof.

c. The Licensee shall assemble and/or manufacture (where such manufacture is authorised in accordance with this Agreement) at a rate sufficient at all times to achieve the greatest market penetration possible for Products in The Territory.

5. Use of Names:

a. The Licensee shall apply to Products such marques and names as are specified in Schedule I hereto or as shall be agreed in writing between the parties hereto and shall not without the prior written permission of the Licensor advertise or supply any Product except under such marques and names and shall not use such marques and names (or any name likely to be confused therewith) except as applied to or in connection with Products.

b. The Licensee shall not without the written consent of the Licensor use the name or initials of the British

associated companies or any name or initials likely to be confused therewith.

- c. The Licensor grants to the Licensee the right to use in The Territory the marques and names included in Schedule I in connection with the sale of the Products and the Licensee hereby undertakes and agrees that it will not attack the use or validity or extent of such marques and names nor shall it assist any third party to do so but shall at all times do all in its power to protect such marques and names and shall ensure that the same remain connected only with the Products as defined in this Agreement and as the Licensor may indicate from time to time.
- d. The right to use such marques and names mentioned in this clause shall in no way give the Licensee any form of proprietary right in respect of such marques or names.

6. Supply of Products:

- a. The Licensor will from time to time use its best endeavours to supply to or procure the supply thereof to the Licensee such Products in knocked down (KD) units or otherwise as in the opinion of the Licensor are applicable to the market of The Territory both in relation to the allocation of import licences and exchange granted by the competent Government authority and to the production capacity for Products of the Licensor which is available for The Territory. The supply of Products by the Licensor relating to any model of Vehicle may be discontinued where in the opinion of the Licensor such supply by virtue of the volumes thereof required by the Licensee can no longer be supplied by the Licensor on a satisfactory economic basis.
- b. The Licensee shall at all times be responsible at its own expense for the safekeeping and good condition of Products after it or its agent have accepted delivery of them and also while the Products are held in stock by the Licensee or its agent.
- c. In the event of any claim by the Licensee regarding purported errors in delivery of Products the Licensee shall supply to the Licensor such information relating to such errors and on such forms as the Licensor may reasonably require from time to time.
- d. The Licensor will endeavour to comply with Customs import currency and vehicle regulations but shall not

be responsible for any loss penalty or other consequence resulting from non-compliance unless agreed in writing by the Licensor after consultation with the Licensee. The delivery of Products by the Licensor shall be made in such manner and at such times and places as the Licensor and Licensee agree but the Licensor and its agents shall not be liable for any failure delay or error in delivery or any consequential loss arising therefrom howsoever caused.

e. Notwithstanding anything herein contained the Licensor shall not be under any liability to supply any Product or make any other deliveries to be supplied or made by it under this Agreement if at the date that such Product is to be supplied or delivered the Licensor has given the Licensee previous notice in writing that:-

- i. any sums which have become due under this Agreement or any of them have not been paid in accordance with the terms of this Agreement; or
- ii. the Licensor has reasonable grounds for believing that any sums which will become due by reason of the delivery of such Product or in respect of any other liability will not be paid in accordance with this Agreement on the due date and the Licensee has not complied with the provisions set out in that notice by the Licensor.

f. The Licensee will in respect of Products ensure that the Licensor before the first day of every month is in receipt of six months firm orders and an estimate of its requirements for twelve months thereafter but such estimate will not constitute a firm commitment on the part of the Licensee or of the Licensor. The period for receipt of firm orders or for an estimate of requirements may be changed by the Licensor from time to time.

g. Any orders for Products placed by the Licensee shall be upon order forms furnished by the Licensor and notwithstanding anything to the contrary in such forms each such order shall be governed by the terms of this Agreement and by the terms of any Distributor Agreement relevant to the Products current at the date of order.



7. Payment for Products:

The Licensee shall pay for all Products purchased from the Licensor and make all other payments under this Agreement in the United Kingdom and in United Kingdom currency (or such other currency as may be agreed in writing between the parties hereto) and in such manner and at such times as may from time to time be mutually agreed between the Licensor and the Licensee.

8. Direct Contracts:

The Licensor reserves the right to enter into direct contracts for the supply assembly or manufacture of Products to Government Municipal authorities and other similar bodies.

9. Local Products:

In addition to those parts which the Licensor has before the date of this Agreement agreed either to supply in unfinished condition for manufacturing completion by the Licensee or to delete from KD units for replacement by local Products the Licensor will from time to time by agreement in writing with the Licensee delete further parts from KD units supplied by the Licensor to be replaced by local Products or supply further unfinished parts for manufacturing completion by the Licensee provided that the Licensor shall not be requested to give such Agreement until:-

- i. samples of each such local Product intended to replace such further parts have been submitted to the Licensor for its approval at the Licensee's expense and have been accepted in writing by the Licensor for both quality and design; and
- ii the Licensee shall at its own expense have satisfied the Licensor that it is able satisfactorily to complete the manufacture of any further unfinished parts so supplied.

The Licensee shall ensure that all local Products approved by the Licensor continue at all times to be supplied in accordance with approved samples and in sufficient quantities for the purposes of this Agreement.

b. The Licensor shall have the right to reject any local Product or any parts finished by the Licensee which shall fall below the standard approved by the Licensor giving the Licensee written reason therefor and advice necessary to remedy any such shortcomings and the Licensee shall make any modification necessary to bring such local Product or finished parts up to such standard or replace the same by a Product ordered from the Licensor.

c. The Licensee shall ensure that every local supplier (that is every person firm or company manufacturing local Products for the Licensee) does so upon terms which preserve the Licensor's rights under this Clause 9. The Licensee shall further use its best endeavours to ensure that every such local supplier supplies local Parts only to the Licensee and to no other person firm or company.

d. With the prior written approval of the Licensor the Licensee may incorporate into its manufacture any modification it may consider desirable to meet any locally peculiar operating conditions with the object of producing products specially suitable for the market in The Territory and with such prior written approval may alter the standard designs of the Licensor accordingly but the Licensor shall not be responsible for any components or parts manufactured by the Licensee nor for any modifications or performance of any units so modified which shall be the entire responsibility of the Licensee both as regards initial design guarantee liability service and the effect which any modified equipment may have on any other components or parts of the Licensor fitted in the Products and in all other respects howsoever arising.

e. Any modification to the Licensor's standard designs which may be introduced by the Licensee shall be made available without cost to the Licensor with the right to incorporate such modification in its own design at any time.

10. Technical Assistance:

In order to facilitate assembly and progressive manufacture of the Products in The Territory the Licensor undertakes as follows:-

- a. The Licensor will supply to the Licensee upon request at the cost of the Licensee in accordance with Clause 11:

- i. manufacturing and assembly drawings
- ii. specifications of material
- iii. description and specifications of material treatment
- iv. laboratory tests and samples; and
- v. continuous advice and technical information and other information adequate for the efficient assembly manufacture and servicing of the Products by the Licensee within The Territory.

Such drawings and information shall be supplied prior to assembly and manufacture being undertaken in accordance with the plant installed by the Licensee and with the programmes to be agreed between the Licensor and the Licensee from time to time. The Licensor cannot provide any information in respect of proprietary parts.

- b. The Licensor will supply to the Licensee upon request at the cost of the Licensee in accordance with Clause 11 all relevant operation sheets and jig and tool drawings relating to the Products which are normally used by the Licensor in corresponding operations for which the data is required but it is understood that all operation sheets are given only as a guide and are based solely on the quantity of the Products being manufactured by the Licensor. Likewise any jig and tool drawings are also intended as a guide and any modification or redesign to suit the plant of the Licensee must be the responsibility of the Licensee. The Licensor shall not be under any obligation to divulge its own manufacturing/assembly operational times. It is understood by the Licensee that all manufacturing drawings supplied by the Licensor under the terms hereof will be the standard drawings used by the Licensor in its own factory and its own dimensions and the Licensor cannot accept any responsibility for altering these dimensions to conform with the Licensee's requirements. In addition material specifications will be

to British standards and the Licensor will have no responsibility for ascertaining equivalents in The Territory.

c. The Licensor will advise the Licensee concerning the purchase of small tools, production equipment, machine tools or heavy machinery required by the Licensee in relation to the assembly and manufacture of the Products.

d. The Licensor will supply to the Licensee upon request at the cost of the Licensee assembly jigs which are manufactured by or for the Licensor.

e. The Licensor will order, procure, or supply against a firm order from the Licensee small tools, production equipment, machine tools or heavy machinery required by the Licensee in relation to the assembly and manufacture of the Products. Such tools, equipment and machinery will be purchased by the Licensor as agent for the Licensee without any responsibility to the Licensor, but the Licensor will pass on to the Licensee the benefit of any Conditions of Business and Guarantee under which the Licensor purchases the tools, equipment or machinery. The Licensee shall be responsible for making payment in full for any tools, equipment or machinery so ordered, procured or supplied.

f. The Licensee will:

i. Be responsible for any expenses incurred by the Licensor in respect of the testing handling and storing of the assembly jigs, tools, machinery and equipment.

ii. Make payment of all packing, carriage, freight insurance and all other charges relating to the supply of the assembly jigs, tools, machinery and equipment to the Licensee or agent.

iii. Pay to the Licensor a handling charge on the following scale:

2½% of the ex works cost of tools  
and machinery or equipment for

- g. The Licensor is responsible for providing information solely in connection with its standard products and has no obligation to undertake special design and development work on behalf of the Licensee but may if requested without cost to the Licensee give an opinion on any reasonable development undertaken by the Licensee provided that no extensive testing examination or engineering is required to give that opinion. Any opinion given is without liability of any kind to the Licensor.

#### 11. Supply of Documents:

The cost to the Licensee of all documents drawings and information referred to in Clause 10 shall be paid by the Licensee in accordance with Schedule 11 of this Agreement. Such costs may be varied by the Licensor from time to time in the event of a reduction or increase in the cost of providing these.

#### 12. Technical Assistance

- a. In order to facilitate the assembly and/or manufacture of the Products to the standard required under the terms hereof the Licensor shall provide in consultation with the Licensee the services of such a number of technicians and other personnel for such periods of time as may be agreed and the Licensee shall be responsible for all costs in respect of such visits to The Territory of such technicians and personnel from the date on which any personnel arrive in The Territory.



The charges (subject to variation from time to time by the Licensor) to be paid by the Licensee are as follows:-

Directors and Senior Executives	£Stg. 50 per day
Managerial Executives	£Stg. 40 per day
Junior Executives and Senior Technicians	£Stg. 30 per day
Technicians and Artisans	£Stg. 20 per day

plus all reasonable living expenses in The Territory and First Class air fare for Directors and Senior Executives and Tourist Class for all other personnel.

b. The Licensor further shall allow and facilitate visits by parties of up to six technicians at any one time being approved representatives of the Licensee to the Licensor's factories in the United Kingdom at such time and for such period of time as may be mutually agreed to inspect and familiarise themselves with and be instructed on manufacture inspection and testing techniques and methods of the Licensor. All costs and expenses in connection with such visits shall be borne by the Licensee. At least one member of each party shall have a working knowledge of the English Language.

### 13. Confidential Information:

The Licensee shall not part with any documents supplied to it and at all times both during the currency of this Agreement and also after the determination thereof shall keep secret and confidential and shall ensure that its employees keep secret and confidential all plans documents and information concerning the manufacture of the Products and any components or parts therefor which are supplied to the Licensee under the terms hereof and shall not, and shall ensure that its employees shall not at any time thereafter disclose any such information to any person firm or company or in any way utilize such information except for the purpose of instructing any authorized sub-contractors as are permitted under this Agreement.

14. Exclusive Supply:

During the currency of this Agreement the Licensee will obtain Products exclusively from the Licensor and from such sources as the Licensor shall specify or approve in writing from time to time and not from any other source unless the same are produced in The Territory by virtue of the authority contained in this Agreement.

Orders for products placed by the Licensee shall specify whether such Products are required for use as original equipment or for sale as spare parts. The manufacture or assembly of Products shall not be sub-contracted to the Licensor's competitors without its prior written consent.

15. Part Numbers:

All parts manufactured by or for the Licensee in The Territory must be identified with a part number which is the same as the corresponding part number of the original part normally supplied by the Licensor but incorporating a special prefix letter or letters and the Licensee shall notify the Licensor in writing and make full details of the proposed prefix letter or letters available to the Licensor three months before production commences in The Territory.

16. Service:

The Licensee shall ensure that adequate and suitable arrangements are available in The Territory in relation to the service facilities (including staff equipment and premises) for Products which it produces under this Agreement and no responsibility shall rest with the Licensor in this respect. The Licensor will supply the Licensee with such information as the Licensor considers appropriate in relation to the service facilities for Products.

17. Changes in Design and Specification:

a. The Licensor reserves the right to make any changes in specification or design in Products at any time without incurring any obligation to incorporate them in any Products delivered to the Licensee. The Licensor

will notify the Licensee of any such changes and give advice on any such changes in accordance with clause 10(a)(v) of this Agreement.

b. The Licensee shall not without the prior written consent of the Licensor (which will not be unreasonably withheld) change the design or specification of any Product nor knowingly do nor after notice continue doing anything that may in any way lessen the validity of any patent or trade mark under which Products are manufactured or sold.

8. Identification Marks:

Except as may be necessary for the assembly of the Products the Licensee shall not alter remove or otherwise hide from sight the serial numbers identification plates and patent numbers as affixed by the Licensor and further more the Licensee shall affix and retain in a visible and suitable manner on all Products all necessary patent numbers.

19. Warranty:

a. Products supplied to the Licensee under this Agreement are sold subject to and with the benefit of the warranties appropriate to the Products (or such variation as the Licensor may from time to time notify to the Licensee) to the exclusion of all other warranties conditions and liabilities whatsoever.

b. The benefit of the warranties is exercisable only by the Licensee who shall include in its Conditions of Sale such provisions as will insure that no legal liability claim or relationship shall arise between the Licensor and any person firm or company purchasing a Product from the Licensee.

c. The Licensee will issue its own Conditions of Sale and Warranty to its customers and the terms and interpretation thereof shall be in conformity with the Licensor's policy as notified to the Licensees in writing from time to time. The Licensee shall give to its customers a warranty the terms of which shall be no less favourable than the warranty given to the Licensee under sub-clause (a) hereof.

20. Indemnity:

a. The Licensee shall indemnify the Licensor against all claims costs liabilities and expenses incurred by the Licensor in respect of or arising out of any defective workmanship in the assembly or manufacturing by the Licensee of Products or in the assembly or manufacture of local Products and in respect of or arising out of defective materials used in local Products.

b. As and when required by the Licensor the Licensee shall furnish the Licensor with particulars of claims and reports made and pending in respect of defective workmanship in Products (including locally made parts) and shall at all reasonable times permit the Licensor or its representatives to inspect the Licensee's record books and accounts relative thereto.

21. Inventions by the Licensee:

If at any time during the continuance of this Agreement the Licensee shall become entitled to any development improvement or invention relating to any of the Products or their assembly manufacture or servicing then (whether or not the same shall be patentable) the Licensee shall forthwith give notice in writing thereof to the Licensor and shall at the request of the Licensor explain the same and the Licensor shall for a period of twelve months from the date of receipt of such notice have the sole right to apply for and obtain in the Licensor's name in all parts of the world (including The Territory) letters patent or similar monopoly rights in respect thereof and the same shall belong to the Licensor absolutely. The Licensee shall at the request and cost of the Licensor execute or procure to be executed such documents as may be necessary to give effect to the provisions of this clause.

22. Royalties:

The Licensee shall pay to the Licensor a royalty on the basis set out in Schedule III of this Agreement.

23. Duration:

This Agreement shall be in force for a period of 10 years

and will continue in forced thereafter unless and until determined by 12 months prior notice in writing given by either party to the other.

24.

International Conflict and Force Majeure:

- a. In the event of a dispute between the Governments of the United Kingdom and The Territory or between either of them and any other country or state or any civil war or insurrection within such country or state which shall result in the cessation or interruption of commerce between the United Kingdom and The Territory either of the parties hereto shall be at liberty to give to the other party notice in writing to suspend this Agreement forthwith until such cessation or interruption has ceased but such suspension shall be without prejudice to the rights of either party which shall have accrued at the time of such cessation or interruption.
- b. If at any time during the continuance of this Agreement it shall become impossible by reason of any strike lock-out combination of workmen trade dispute difficulty in obtaining workmen or materials or by reason of Government direction accident fire hostilities (whether war has been declared or not) civil riot requisitioning by Government or any other circumstances of force majeure beyond the control of either party for it to fulfill its obligations under this Agreement neither party shall by reason of such impossibility alone be entitled to determine this Agreement or have any claim against the other and on determination of such event as above deliveries and assembling and manufacturing (as the case may be) shall be resumed within a reasonable time.

25.

Termination:

The Licensor shall have the right to terminate this Agreement on giving notice in writing to the Licensee if:-

- a. the Licensee's assembly and manufacturing plants are in the opinion of the Licensor utilized for purposes other than those anticipated by this Agreement to such an extent that it is to the detriment of the Licensor and the Licensee has not rectified this



b. Any amounts payable by the Licensee to the Company under the provisions of this Agreement shall be in arrear and remain unpaid for more than ninety days after the due date of payment.

c. The Licensee shall have committed any breach of its obligations under this Agreement and fails to rectify such breach within thirty days of being requested to do so.

d. The Licensee shall go into liquidation other than for the purpose of reconstruction or amalgamation or become insolvent or a receiver of any of its assets shall be appointed or cease or threaten to cease to carry on business.

e. If there is any change in the shareholding control or management of the Licensee which in the opinion of the Company would make it detrimental to the interests of the Company to continue to be bound by this Agreement.

f. If the Licensee attempts in any way to assign this Agreement.

26. Obligations upon Termination:

The Licensor and the Licensee hereby agree that upon termination of this Agreement for any reason the following provisions shall apply:

i. the Licensee will continue to observe the conditions of Clause 13 hereof.

ii. the Licensee shall forthwith cease the manufacture and assembly of Products and thereafter shall not manufacture or assemble any Products nor in any way procure or assist in the manufacture or assembly of the same by any third party except as may be necessary to complete orders given to and accepted by the Licensor prior to the date of notice of termination.

iii. the Licensor may cancel all or any orders placed with it by the Licensee and unexecuted at the date of termination of this Agreement.

- v the continuance by the Licensee to order Products or by the Licensor to supply Products shall not be construed as renewal of the terms of this Agreement for any specific period nor as a waiver of its termination but all orders placed by the Licensee and accepted by the Licensor and all manufacture assembly and sale of Products after the date of termination shall unless otherwise agreed be governed by the terms of this Agreement so far as they may be applicable.
- v. The Licensee shall forthwith return to the Licensor all equipment supplied to the Licensee or any of its agents on loan and all drawings and specifications, lists, models, records, instructions and other information supplied by the Licensor free of charge or on loan and any copies thereof so far as the same are at the date when notice of termination is given in the possession or control of the Licensee or shall come into its possession or under its control thereafter.
- vi. Such termination shall be without prejudice to the rights and obligations of either party arising prior to such termination and shall also be without prejudice to those provisions herein contained which govern the rights and obligations of the parties on and after termination.

**27. Further Obligations on Termination:**

Within a reasonable time after the termination of this Agreement for whatsoever cause the Licensor shall have the option by notice in writing to the Licensee to repurchase at the price paid by the Licensee to the Licensor any or all unused K.D. material and/or Parts in current demand which shall be in the possession of the Licensee at the time of the receipt by the Licensee of such notice and upon tender by the Licensor of that purchase price the Licensee at its own expense shall deliver K.D. material and/or Parts to the Licensor and the Licensee shall without charge to the Licensor deliver such K.D. material and/or Parts in accordance with the Licensor's delivery instructions.

28. Representation after Termination:

- a. The Licensee shall not be released from any obligation arising from any transaction entered into with the Licensor prior to termination of this Agreement.
- b. The Licensee shall as soon as practicable and in any event within two months of termination of this Agreement and thereafter discontinue the use of the names or initials of the Licensor, the Products or The British Leyland Motor Corporation Limited or any name, initials or expression resembling them and the Licensee shall also within that period discontinue all advertisements signs and notifications that it is a Licensee of or dealing in the Licensor's Products.
- c. The Licensee shall upon termination remove and thereafter discontinue all advertisements, signs, and notifications that it is a Licensee of or dealing in the Licensor's Products.

29. Variation of Agreement:

This Agreement and the annexures to it constitute the whole of the Agreement between the Licensor and the Licensee in respect of the assembly and manufacture of Vehicles and Parts therefor in The Territory notwithstanding any prior negotiation or correspondence existing. No variation alteration or abandonment of any of its terms shall have effect unless made in writing by the Licensee or its duly authorized representative and by a duly authorized representative of the Licensor.

30. Prohibition on Assignment:

This Agreement and the rights of the Licensee and all information supplied under this Agreement shall except as expressly provided for in this Agreement be personal to the Licensee and cannot be assigned charged or disposed of by the Licensee in whole or in part in any way whatever except with the prior written consent of the Licensor which shall not be unreasonably withheld in the case of a wholly owned subsidiary of the Licensee.

31. English Law:

- a. This Agreement shall be construed in accordance with English Law.

b. The illegality or invalidity of any part of this Agreement shall not affect the legality or validity of the remainder thereof.

32. The headings notes are for reference only and shall not affect the interpretation of this Agreement.

IN WITNESS WHEREOF these presents have been executed the day and year first hereinbefore written.

## APPENDIX F

### 1992 KENYA VEHICLE SALES STATISTICS (Locally assembled vehicles only)

	1992 SALES	MARKET SHARE %	1991 SALES	MARKET SHARE	%SALES CHANGE	%SHARE CHANGE
<u>TYPES</u>						
PASSENGER CARS	2749	32.8	2792	29.5	-1.5	3.3
PICK-UPS	2113	25.2	2806	29.7	-24.7	-4.4
4WD	918	11.0	992	10.5	-7.5	0.5
LIGHT TRUCKS	871	10.4	1013	10.7	-14.0	-0.3
HEAVY TRUCKS	650	7.8	895	9.5	-27.4	-1.7
MINIBUSES	587	7.0	580	6.1	1.2	0.9
BUSES	484	5.8	377	4.0	28.4	1.8
<b>TOTAL</b>	<b>8372</b>		<b>9455</b>		<b>-11.5</b>	
<u>MAKES</u>						
NISSAN	1767	21.1	1848	19.5	-4.4	1.6
ISUZU	1559	18.6	1587	16.8	-1.8	1.8
TOYOTA	1108	13.2	1273	13.5	-13.0	-0.2
PEUGEOT	956	11.4	1085	11.5	-11.9	-0.1
MITSUBISHI	893	10.7	1392	14.7	-35.8	-4.1
MAZDA	455	5.4	597	6.3	-23.8	-0.9
SUZUKI	267	3.2	390	4.1	-31.5	-0.9
DAIHATSU	222	2.7	210	2.2	5.7	0.4
NISSAN-UD	210	2.5	185	2.0	13.5	0.6
OPEL	199	2.4	24	0.3	729.2	2.1
MITSUBISHI-FUSO	159	1.9	317	3.4	-49.8	-1.5
LANDROVER	152	1.8	100	1.1	52.0	0.8
HONDA	95	1.1	97	1.0	-2.1	0.1
SUBARU	89	1.1	90	1.0	-1.1	0.1
FIAT-AUTO	60	0.7	67	0.7	-10.4	0.0
VOLKSWAGEN	44	0.5	33	0.3	33.3	0.2
LEYLAND-DAF	39	0.5	41	0.4	-4.9	0.0
TATA	36	0.4	3	0.0	1100.0	0.4
HINO	20	0.2	15	0.2	33.3	0.1
MINI-MOKE	16	0.2	5	0.1	220.0	0.1
FIAT-IVECO	11	0.1	26	0.3	-57.7	-0.1
VOLVO	6	0.1	17	0.2	-64.7	-0.1
NIVA	5	0.1	16	0.2	-68.8	-0.1
BEDFORD	2	0.0	5	0.1	-60.0	0.0
MERCEDES-BENZ	2	0.0	32	0.3	-93.8	-0.3
<b>TOTAL</b>	<b>8372</b>		<b>9455</b>		<b>-11.5</b>	



END YEAR REVIEW

1992 KENYA VEHICLE SALES STATISTICS (Locally assembled vehicles only)

	1992 SALES	MARKET SHARE %	1991 SALES	MARKET SHARE	%SALES CHANGE	%SHARE CHANGE
<u>TYPES</u>						
PASSENGER CARS	2749	32.8	2792	29.5	-1.5	3.3
PICK-UPS	2113	25.2	2806	29.7	-24.7	-4.4
4WD	918	11.0	992	10.5	-7.5	0.5
LIGHT TRUCKS	871	10.4	1013	10.7	-14.0	-0.3
HEAVY TRUCKS	650	7.8	895	9.5	-27.4	-1.7
MINIBUSES	587	7.0	580	6.1	1.2	0.9
BUSES	484	5.8	377	4.0	28.4	1.8
<b>TOTAL</b>	<b>8372</b>		<b>9455</b>		<b>-11.5</b>	
<u>MAKES</u>						
NISSAN	1767	21.1	1848	19.5	-4.4	1.6
ISUZU	1559	18.6	1587	16.8	-1.8	1.8
TOYOTA	1108	13.2	1273	13.5	-13.0	-0.2
PEUGEOT	956	11.4	1085	11.5	-11.9	-0.1
MITSUBISHI	893	10.7	1392	14.7	-35.8	-4.1
MAZDA	455	5.4	597	6.3	-23.8	-0.9
SUZUKI	267	3.2	390	4.1	-31.5	-0.9
DAIHATSU	222	2.7	210	2.2	5.7	0.4
NISSAN-UD	210	2.5	185	2.0	13.5	0.6
OPEL	199	2.4	24	0.3	729.2	2.1
MITSUBISHI-FUSO	159	1.9	317	3.4	-49.8	-1.5
LANDROVER	152	1.8	100	1.1	52.0	0.8
HONDA	95	1.1	97	1.0	-2.1	0.1
SUBARU	89	1.1	90	1.0	-1.1	0.1
FIAT-AUTO	60	0.7	67	0.7	-10.4	0.0
VOLKSWAGEN	44	0.5	33	0.3	33.3	0.2
LEYLAND-DAF	39	0.5	41	0.4	-4.9	0.0
TATA	36	0.4	3	0.0	1100.0	0.4
HINO	20	0.2	15	0.2	33.3	0.1
MINI-MOKE	16	0.2	5	0.1	220.0	0.1
FIAT-IVECO	11	0.1	26	0.3	-57.7	-0.1
VOLVO	6	0.1	17	0.2	-64.7	-0.1
NIVA	5	0.1	16	0.2	-68.8	-0.1
BEDFORD	2	0.0	5	0.1	-60.0	0.0
MERCEDES-BENZ	2	0.0	32	0.3	-93.8	-0.3
<b>TOTAL</b>	<b>8372</b>		<b>9455</b>		<b>-11.5</b>	

# 1992 KENYA VEHICLE SALES STATISTICS (Locally assembled vehicles only)

	1992 SALES	MARKET SHARE %	1991 SALES	MARKET SHARE	%SALES CHANGE	%SHARE CHANGE
<b><u>SOURCES</u></b>						
JAPAN	6844	81.7	8001	84.6	-14.5	-2.9
FRANCE	956	11.4	1085	11.5	-11.9	-0.1
GERMANY	245	2.9	89	0.9	175.3	2.0
GT. BRITIAN	209	2.5	151	1.6	38.4	0.9
ITALY	71	0.8	93	1.0	-23.7	-0.1
INDIA	36	0.4	3	0.0	1100.0	0.4
SWEDEN	6	0.1	17	0.2	-64.7	-0.1
RUSSIA	5	0.1	16	0.2	-68.8	-0.1
<b>TOTAL</b>	<b>8372</b>		<b>9455</b>		<b>-11.5</b>	

## **SMALL-MEDIUM SALOONS**

NISSAN SUNNY	518	28.9	606	31.8	-14.5	-3.0
TOYOTA COROLLA	277	15.4	281	14.8	-1.4	0.7
MITSUBISHI LANCER	270	15.0	394	20.7	-31.5	-5.7
OPEL ASTRA	199	11.1	24	1.3	729.2	9.8
DAIHATSU CHARADE	166	9.2	189	9.9	-12.2	-0.7
MAZDA 323	125	7.0	130	6.8	-3.8	0.1
HONDA CIVIC	95	5.3	97	5.1	-2.1	0.2
PEUGEOT 205	69	3.8	103	5.4	-33.0	-1.6
FIAT UNO	60	3.3	67	3.5	-10.4	-0.2
MINI-MOKE	16	0.9	5	0.3	220.0	0.6
VW GOLF			7	0.4	-100.0	-0.4
SUZUKI SKYLARK						
<b>TOTAL</b>	<b>1795</b>		<b>1903</b>		<b>-5.7</b>	

## **SMALL-MEDIUM STATION WAGONS**

NISSAN SUNNY	119	58.0	141	52.4	-15.6	5.6
MAZDA 323	45	22.0	44	16.4	2.3	5.6
TOYOTA COROLLA	21	10.2	40	14.9	-47.5	-4.6
MITSUBISHI LANCER	20	9.8	44	16.4	-54.5	-6.6
<b>TOTAL</b>	<b>205</b>		<b>269</b>		<b>-23.8</b>	

## **LARGE SALOONS**

PEUGEOT	521	87.4	402	81.7	29.6	5.7
VW GOLF	44	7.4	25	5.1	76.0	2.3
TOYOTA COROLLA	31	5.2	65	13.2	-52.3	-8.0
<b>TOTAL</b>	<b>596</b>		<b>492</b>		<b>21.1</b>	

# END YEAR REVIEW

## 1992 KENYA VEHICLE SALES STATISTICS (Locally assembled vehicles only)

	1992 SALES	MARKET SHARE %	1991 SALES	MARKET SHARE	%SALES CHANGE	%SHARE CHANGE
<b><u>LARGE STATION WAGONS</u></b>						
PEUGEOT	97	63.4	90	70.3	7.8	-6.9
SUBARU	56	36.6	38	29.7	47.4	6.9
<b>TOTAL</b>	<b>153</b>		<b>128</b>		<b>19.5</b>	
<b><u>4X4 VEHICLES</u></b>						
TOYOTA	135	14.7	119	12.0	13.4	2.7
SUZUKI	267	29.1	390	39.3	-31.5	-10.2
MITSUBISHI PAJERO	192	20.9	211	21.3	-9.0	-0.4
LANDROVER	152	16.6	100	10.1	52.0	6.5
ISUZU TROOPER	111	12.1	135	13.6	-17.8	-1.5
DAIHATSU ROCKY	56	6.1	21	2.1	166.7	4.0
NIVA	5	0.5	16	1.6	-68.8	-1.1
<b>TOTAL</b>	<b>918</b>		<b>992</b>		<b>-7.5</b>	
<b><u>HALF-TON PICK-UPS</u></b>						
NISSAN 1200	384	75.0	429	64.2	-10.5	10.8
MAZDA MUIJIZA	95	18.6	187	28.0	-49.2	-9.4
SUBARU	33	6.4	52	7.8	-36.5	-1.3
<b>TOTAL</b>	<b>512</b>		<b>668</b>		<b>-23.4</b>	
<b><u>ONE TON PICK-UPS (INCLUDING 4WD)</u></b>						
TOYOTA HILUX	507	31.7	548	25.6	-7.5	6.0
ISUZU TFR	327	20.4	418	19.6	-21.8	0.9
NISSAN SAHARA	308	19.2	266	12.4	15.8	6.8
PEUGEOT	269	16.8	490	22.9	-45.1	-6.1
MAZDA B1600	110	6.9	167	7.8	-34.1	-0.9
MITSUBISHI L200	80	5.0	249	11.6	-67.9	-6.6
<b>TOTAL</b>	<b>1601</b>		<b>2138</b>		<b>-25.1</b>	
<b><u>MINIBUSES</u></b>						
NISSAN URVAN	438	74.6	387	66.7	13.2	7.9
TOYOTA HIACE	135	23.0	178	30.7	-24.2	-7.7
MITSUBISHI L300	14	2.4	14	2.4	0.0	0.0
VW TRANSPORTER	0	0.0	1	0.2	-100.0	-0.2
<b>TOTAL</b>	<b>587</b>		<b>580</b>		<b>1.2</b>	

**1992 KENYA VEHICLE SALES STATISTICS (Locally assembled vehicles only)**

	1992 SALES	MARKET SHARE %	1991 SALES	MARKET SHARE	%SALES CHANGE	%SHARE CHANGE
<b><u>MEDIUM BUSES</u></b>						
ISUZU	308	84.4	198	81.8	55.6	2.6
MITSUBISHI ROSA	30	8.2	0	0.0	100.0	8.2
MITSUBISHI CANTER	25	6.8	35	14.5	-28.6	-7.6
LEYLAND-DAF	2	0.5	6	2.5	-66.7	-1.9
MAZDA			3	1.2	-100.0	-1.2
<b>TOTAL</b>	<b>365</b>		<b>242</b>		<b>50.8</b>	
<b><u>LARGE BUSES</u></b>						
NISSAN-UD	46	38.7	63	46.7	-27.0	-8.0
ISUZU	40	33.6	61	45.2	-34.4	-11.6
LEYLAND-DAF	26	21.8	9	6.7	188.9	15.2
MITSUBISHI-FUSO	6	5.0	2	1.5	200.0	3.6
TATA	1	0.8			100.0	0.8
<b>TOTAL</b>	<b>119</b>		<b>135</b>		<b>-11.9</b>	
<b><u>LIGHT TRUCKS (2 - 6 TONS)</u></b>						
ISUZU NKR	527	60.5	451	44.5	16.9	16.0
MITSUBISHI CANTER	262	30.1	445	43.9	-41.1	-13.8
MAZDA T4100	80	9.2	66	6.5	21.2	2.7
TOYOTA DYNA	2	0.2	32	3.2	-93.8	-2.9
NISSAN CABSTAR			19	1.9	-100.0	-1.9
<b>TOTAL</b>	<b>871</b>		<b>1013</b>		<b>-14.0</b>	
<b><u>6 - 9 TON TRUCKS</u></b>						
ISUZU	126	62.1	215	63.0	-41.4	-1.0
MITSUBISHI-FUSO	62	30.5	111	32.6	-44.1	-2.0
NISSAN DIESEL	12	5.9		0.0	100.0	5.9
BEDFORD	2	1.0	5	1.5	-60.0	-0.5
HINO	1	0.5		0.0	100.0	0.5
TOYOTA			10	2.9	-100.0	-2.9
<b>TOTAL</b>	<b>203</b>		<b>341</b>		<b>-40.5</b>	

**1992 KENYA VEHICLE SALES STATISTICS (Locally assembled vehicles only)**

	1992 SALES	MARKET SHARE %	1991 SALES	MARKET SHARE	%SALES CHANGE	%SHARE CHANGE
<b><u>9 - 15 TON TRUCKS</u></b>						
NISSAN-DIESEL	138	32.8	112	21.7	23.2	11.1
ISUZU	120	28.5	109	21.1	10.1	7.4
MITSUBISHI-FUSO	87	20.7	196	37.9	-55.6	-17.2
TATA	35	8.3	3	0.6	1066.7	7.7
HINO	19	4.5	15	2.9	26.7	1.6
LEYLAND-DAF	11	2.6	26	5.0	-57.7	-2.4
FIAT	9	2.1	26	5.0	-65.4	-2.9
MERCEDES-BENZ	2	0.5	30	5.8	-93.3	-5.3
<b>TOTAL</b>	<b>421</b>		<b>517</b>		<b>-18.6</b>	
END YEAR REVIEW						

**1992 KENYA VEHICLE SALES STATISTICS (Locally assembled vehicles only)****OVER 15 TON + PRIME MOVERS**

NISSAN-DIESEL	14	53.8	10	27.0	40.0	26.8
VOLVO	6	23.1	17	45.9	-64.7	-22.9
MITSUBISHI-FUSO	4	15.4	8	21.6	-50.0	-6.2
FIAT	2	7.7		0.0	100.0	7.7
MERCEDES-BENZ			2	5.4	-100.0	-5.4
<b>TOTAL</b>	<b>26</b>		<b>37</b>		<b>-29.7</b>	



# APPENDIX G

